

Farmers (ATG) Chapter Nine - Grain

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Introduction

Farming Basics – Risks, Crops and Production Cycle

Risk

All businesses, including farming, are subject to many risks and require various decisions to minimize and overcome these risks. Historically, the farmer has retained the risks associated with farming, i.e., taken his or her chances with fate. Today's farmer has a substantial investment in fixed assets and planting production costs, so the risks are even higher. A prudent business person needs to reduce some of the risk to remain in business and have some certainty in the future. The farmer must make many difficult decisions in how much risk shifting can be afforded.

The farming industry differs from other businesses as it is a true competitive, market-driven industry. The farmer has no control over the price received, and all crops produced may be sold at the same price. If the farmer does not use marketing strategies the inability to control price is a major risk confronting the farmer, especially since the production cycle generally occurs on a yearly basis. Furthermore, the farmer has no control over the prices of the fuel, fertilizer, chemicals, and equipment used in the production of grain.

Unlike other businesses, nature is a significant risk in farming. Entire crops can be destroyed by a natural disaster such as drought, flood, or hail. Crop diseases and pests can also cause major losses and even destroy an entire crop.

Nature and market price risks make farming a series of high stake gambles. However, both market price and nature risks can be minimized.

- Risks from nature can be shifted by buying crop insurance. This shifts the risk to a pool of similar participants. The amount of coverage is variable so more or less of the risk can be reduced.
- Market price risk can be reduced in three ways:
 - Sell forward contracts at agreed prices to hedge the risk of price declines. A forward contract may also be used to reduce the risk of price increases in connection with acquisitions of inventory and non-inventory supplies.
 - Sell regulated futures contracts, through which the risk is transferred to a speculator who buys the contract. This is known as hedging. The principle risk of hedging is the lost income opportunity if the market price should go up.
 - Participate in the Government's farm programs, through which the farmer receives a deficiency payment (the difference between a set price and the market price).

Crop/Grain Production Cycles

There are many different kinds of crops produced by today's farmers. Most of these crops are planted in the spring and harvested in the fall. An exception is winter wheat, which is planted in the fall and harvested in June and/or July. It is very important to remember when you examine farm returns that you do not schedule work with the farmer during planting and harvest. If you schedule an on-farm appointment during this time period, the farmer will quickly get the impression that you know very little about farming.

When auditing a farm operation, it is essential that you understand the production and distribution cycles of the crops grown by the farmer. In other industries, you are able to walk into a manufacturer's place of business and view the production cycle from raw goods to finished product. In a farm operation you can only see one stage of the production cycle at a time. This chapter is meant to familiarize you with the production cycles of feed grains grown by U.S. producers.

Following this introduction, you will find a short description of the production cycles of the major feed grain - wheat, corn, soybeans, and sorghum. Alfalfa is also included since it is a major crop grown on some grain farms and has a distinctly different production cycle. Cereal grains such as oats, barley, and rye have production cycles similar to wheat.

You should become aware of the crops grown in your area. If you need more production information on the crops described in this section or on other crops in your area, you can contact your local county extension office.

Wheat

Wheat is one of the major grains produced for human consumption. Wheat is a stemmed annual grass plant with a single head that produces the grain. Wheat is unusual in that it can be planted at two different times of the year. Some wheat is planted in the spring and harvested in the fall. However, in the central and southern areas of the Great Plains, wheat is planted in the late fall and harvested the following spring. This wheat is commonly called winter wheat. Soft spring wheat is generally used as feed or to make flour for pasta, while hard winter wheat is milled for flour. By planting winter wheat, farmers can also plant another crop in the late spring to early summer to be harvested in the fall. This allows the farmer to receive income from two crops in the same year, and is commonly referred to as double cropping. The rest of this section will concentrate on the production of winter wheat.

Winter Wheat

Winter wheat is the only crop whose growing season includes winter. Thus, it has the longest production period. The seed is planted in the fall, and the plant becomes established before it goes into winter dormancy. The growing season starts in the late winter, with spring rains feeding the plant growth and grain development. Ideally, the wheat is harvested before the hottest and driest parts of summer arrive. In areas of marginal rainfall, land is usually left fallow (idle) to allow moisture retention for the next crop. In areas of higher rainfall and a longer growing season, a second crop (soybeans or

milo) is often planted right after wheat harvest, giving rise to the concept of double cropping. Double cropping wheat with soybeans provides a major part of the nitrogen, which is the primary nutrient needed by wheat.

Soil Preparation and Planting (Wheat)

Most wheat is grown on highly erodible land, resulting in conservation tillage methods being used. A field cultivator or disc is used to till the prior crop's stubble or stalks. Wheat is then planted using a drill, which places the seed into the soil in very narrow rows using coulters (disc) and shoes to open the row. Spring-loaded packing wheels then tamp the row, resulting in a better seed to soil contact. Seed wheat can also be drilled directly into the ground without any prior tillage in a process called “no-till”.

Fertilization (Wheat)

Fertilizer use is generally limited to nitrogen, phosphorous, and potassium. All three can be applied as pre-plant or phosphorous and potassium can be applied at planting. In addition to the pre-plant application, nitrogen should also be applied in early spring.

Harvesting and Storage (Wheat)

Wheat is harvested by a combine. Harvesting may be done by the farmer or by custom harvest crews. If custom harvesters are used, you need to review the harvesting contract or contact your local county extension agent for the average rates charged. Custom harvesting is normally billed on an established amount per acre plus an additional charge per bushel. A farmer who has row crops, in addition to wheat, usually owns a combine, which can be used to harvest all grain crops grown.

Ideally wheat is harvested at a minimum level of moisture so it can be stored without drying. Ripe wheat is quite susceptible to wind and/or moisture damage, thus timing is critical when the grain is ready to harvest. For this reason, when scheduling an appointment with a wheat farmer, contact the farmer first so you do not schedule an examination during harvest.

Marketing (Wheat)

Harvested wheat is usually trucked out of the fields during harvest and taken to the local co-op or elevator. The farmer will either store the wheat or sell it to the elevator. Wheat is usually stored to be sold when market conditions are most advantageous. Since most wheat is ground into flour, it must be transported to some type of elevator to await further shipment. Therefore, most wheat sales will be to the local elevator. When wheat has such a poor quality (for example, unable to timely harvest due to rain) that it may be severely docked (price cut) if sold, or if wheat prices are low in comparison to corn prices, the wheat may be used as feed by the farmer or sold to the feedlots for feed.

Wheat can be retained for seed wheat. Seed wheat may be used by the farmer for the next year's crop or sold to other farmers for seed. The young, growing wheat can also be used for cattle grazing in the winter without damaging the resulting grain crop. When interviewing the taxpayer, make sure to ask about other sources of income from wheat pasture and seed wheat, etc. Wheat is typically sold by the bushel (60 pounds).

Corn

Corn is used as a feed grain, for human consumption and for ethanol production. It is the principle feed grain grown in America. Corn requires good soil and large amounts of water, but produces many more bushels per acre than other feed grains. It is grown throughout the country, but the Midwest farm belt is the primary producing area. Because of the need for large amounts of water, corn is often irrigated where water sources are available. The production potential difference between irrigated and non-irrigated land is quite substantial, so it is necessary to ascertain how many acres of corn are irrigated.

Corn is a stemmed annual grass plant that can grow to 7 or 8 feet tall. It is pollinated from the tassels, and produces one to two ears per plant. It grows rapidly with large quantities of water, and hot, windy weather. Corn is susceptible to various worms and insects which require pesticides to control. Weed control is also necessary because of the long growing season.

Soil Preparation (Corn)

Plowing was the conventional method of preparing the ground for planting. It is less commonly used now as it is expensive in terms of fuel, labor, and equipment. It also can cause sloped fields to become susceptible to topsoil erosion from wind and rain. To conserve topsoil and reduce the costs of producing the crop without a corresponding drop in income (yield), farmers are using more conservation tillage, often called no-till or low-till. Conservation tillage allows plant residue to be maintained in the field and is now widely used by the farming industry. In addition to reducing erosion, these methods reduce the number of trips over the field for soil preparation and cultivation. Field cultivators are replacing the plow.

Highly erodible land must maintain a certain percentage of plant residues to reduce erosion in order for the farmer to remain eligible for any Government subsidies on that land.

Planting (Corn)

Corn is planted in rows using a row crop type of planter, which can also be used for planting milo and soybeans. The corn may be cultivated several times for weed control and soil aeration. If no-till or low-till procedures are used, the need for cultivation is eliminated; however, special planters are required, and herbicides must be applied to control weeds.

Corn requires large amounts of fertilizer, particularly nitrogen. Nitrogen may be applied before planting, at planting time, or as a side-dressing after the corn is up. Total fertilizer use is greater on corn than on any other crop grown in the United States.

Irrigation (Corn)

Corn requires more rainfall than other crops. It has two short, critical growing periods (tasseling and silking) where lack of water can cause severe yield losses. Irrigation will result in significantly higher yields over dry land production. Irrigation will be used where there are adequate water sources and inadequate rainfall.

Early irrigation was done exclusively by flooding on flat bottom land, where water would run down the furrows from one end of the field to the other. This often required the fields to be leveled. This method is labor intensive and cannot be used if there are any hills, but it is still in use today in certain areas.

Most irrigation of corn (and other crops) is now done by center pivot systems. The water enters at the center pivot into a long length of overhead pipe where it is sprinkled onto the field. A mast assembly with drive wheels supports the pipe and moves the sprinkler around in a circle. Some systems have a boom on the end which is controlled to extend at the corners so the coverage is closer to a square than a circle. Once set up, it can irrigate a field for the growing season with minimal labor.

In most areas, the water is supplied by wells from an underground aquifer. Because irrigation depletes the aquifer, some states now exercise more control over usage and drilling new wells.

Irrigation requires a substantially higher initial investment in land, equipment, and water wells. Well pump operation also increases expenses.

Harvesting (Corn)

The corn is harvested in the fall (usually October) by combines with corn head attachments. Corn heads cannot be used for any other type of crop. The corn is shelled off the cob by the combine so that only the grain is hauled out of the field. Dry grain corn yield is measured by the bushel (56 pounds). Because wet corn is susceptible to mold, it is often dried before storage and aerated afterward. Dryers require large amounts of fuel (propane). Corn can also be stored in wet bins such as “Harvestores,” which control the air. The wet corn is usually fed to livestock on the farm, since it cannot be sold and shipped outside of the area. Corn pickers may still be used in some areas where the corn is left on the cob and stored in cribs to dry naturally. This ear corn can be ground into livestock feed or shelled the next year. Ear corn is usually not marketed until the following year.

Silage (Corn)

Due to its high fiber and nutrient content, the entire corn plant can be chopped into silage for cattle feed before the plant matures and dries up. During times of drought, corn may be chopped for feed to salvage some of the plant when there would be very little grain produced. Silage is most often produced for the farmer's own livestock, but it can be sold to other livestock feeders. It is typically used to fatten cattle.

Marketing (Corn)

After the corn is harvested, it can be stored on the farm for future sale or consumption, hauled to an elevator for sale or storage, or sold to feed consumers. Feedlots are the largest consumers of corn. Corn farmers will usually have sufficient on-farm storage for a typical crop, especially if the corn is used as livestock feed. The on-farm storage facilities also allow the farmer to seal (store) the corn through CCC loans made on the stored grain (see Government Farm Programs chapter).

By marketing the corn and silage as feed for livestock, the farmer can reduce drying, handling and hauling costs. The corn stalks remaining in the field after harvest can be used as pasture for cattle or baled for bedding.

Soybeans

Soybeans are a row crop with a production cycle similar to corn. They are high in protein and have a variety of uses. Soybeans require less moisture than corn so their importance to the farmer has continued to grow over the last few decades.

Soybeans are broad-leaf plants which produce beans within their pods. They grow about 2 to 3 feet high. Unlike corn and sorghum, soybeans do not generate a lot of material in their stalks or roots, thus the soil is more susceptible to erosion. Soybeans are often rotated with corn for several reasons:

- Corn is a grass while soybeans are a broad-leaf
- Rotating corn and soybeans allows the use of different herbicides, which can break up the pest cycles
- Soybeans are a legume which add nitrogen to the soil for a subsequent corn crop
- Corn can be planted in soybean ground with little or no tillage.

Double Cropping (Soybeans)

While soybeans can be planted as a single crop during the year, because of their shorter growing season, they are often used for double cropping. For instance, the farmer harvests his or her winter wheat crop in June and plants a soybean crop in the wheat stubble. This allows the growing and harvesting of two crops in a single year. Double cropping is normally found in the middle and southern areas of the United States where the growing season is longer.

Harvesting and Uses (Soybeans)

Soybeans are harvested in the fall by a combine using a row crop head attachment. They are processed by extrusion, which means soybean oil is extracted from the meal when the bean is crushed. Both oil and meal are used for various human food products, but the meal is also a primary protein source in livestock feed. Raw soybeans are not fed directly to livestock. Since farmers cannot process soybeans themselves, they must sell their soybeans either to elevators or directly to soybean processors. Large processors, such as Con-Agra, Cargill, and Archer Daniels Midland (ADM), have large soybean collection points, which help the farmer to eliminate the elevator middleperson.

Soybean production is currently undergoing a significant change. More soybeans are being planted like the cereal grains with a drill, rather than as a row crop. This means that soybeans are now being grown more like wheat than like corn. Like wheat and corn, soybeans are sold by the bushel.

Sorghum (Milo)

Grain sorghum is a row crop with a production cycle similar to corn's; therefore, only the differences will be emphasized.

Sorghum is a grass plant similar to corn, but the grain grows on a head like wheat, rather than on ears. Sorghum generally grows to a height of about 3 feet, but some types, especially those used for silage, will grow much taller, creating more plant to be chopped for feed.

Planting (Sorghum)

Sorghum is planted about the same time as soybeans (anytime from late April to early July). Its growing period is shorter than corn's, making it more drought resistant.

Sorghum can be grown in areas that do not have enough rainfall for corn production. Although irrigation is not always necessary, the potential production difference (as with corn) between irrigated and non-irrigated land is substantial. It is often grown in rotation either with soybeans or wheat. It is also used as a double crop with wheat, and it is planted right after the wheat has been harvested.

Harvesting (Sorghum)

Sorghum is harvested in the fall by a combine using a row crop head attachment (under proper conditions, a reel attachment may also be used). Sorghum is used primarily as feed for livestock. The milo stubble (stalk residue) remaining in the field can be used as pasture for cattle, but the cattle cannot be turned onto the stubble until at least 3 days after a killing frost. During drought years milo stalks can contain prussic acid, which is fatal to cattle.

Alfalfa

Alfalfa, a flowering plant with a purple bloom, is the principal hay crop grown in the United States. It is a substantial source of protein and fiber for livestock feed. It is the only major field crop that can be harvested several times in one growing season and is a perennial (continues to grow year after year). It is a legume, meaning it adds nitrogen to the soil which can be used by any subsequent crop planted. This makes it an important part of crop rotation plans. Alfalfa responds well to irrigation and is a viable alternative to irrigated corn when the water supply is limited. It is drought-tolerant. Usually, only production is lost, not the plant itself.

Soil Preparation and Planting (Alfalfa)

Soil preparation is similar to wheat, using a field cultivator and a disc. Planting is usually done by a drill, but alfalfa can be planted by broadcasting, with a cover/companion crop of spring oats. The oats help shade and protect the young alfalfa plants. The oats are removed early, by either cutting, baling or by combining for the oat grain, to allow better alfalfa growth. If the oats are combined, the oat straw is then baled so it will not be collected with the first alfalfa crop. Once planted, alfalfa has a lifespan of 5-8 years.

Grazing (Alfalfa)

Livestock will bloat and possibly die from overgrazing on growing alfalfa. Grazing livestock on growing alfalfa requires constant supervision and is seldom done in livestock feeding operations.

Harvesting and Storage (Alfalfa)

Alfalfa is usually cut at the one-tenth bloom stage, with new growth starting at the crown of the plant. Alfalfa can generally grow to maturity every 28 to 30 days, depending on growing conditions and the amount of water available. This allows the harvesting of three to five crops per year. Alfalfa harvesting is done by baling, stacking or chopping. The alfalfa is cut directly in chopping, but baling and stacking requires three separate preliminary steps:

1. Cutting
2. Conditioning
3. Windrowing

Alfalfa can be cut using a sickle mower. This requires subsequent trips by a conditioner and then a rake. A conditioner crimps (crushes) the stems which speeds the drying process. A rake gathers the alfalfa into a windrow (a large, continuous row of intertwined hay). A rake can also be used to turn a windrow over to accelerate drying. Alfalfa must be cured and dried before it is baled. A swather/windrower can cut condition and windrow in just one pass.

Most alfalfa is harvested by baling. Baling can be done in small or large bales, and the bales can be either square or round. Small square (actually rectangular) bales are tied by

two strands of either wire or twine. The small bales are better suited for inside storage, but more labor is required, even with bale handling equipment. Large bales both round and square, are being used much more extensively now. These are handled exclusively by mechanical equipment.

Large round bales are produced by the baler picking up the windrows, rolling them into large horizontal cylinders and then tying them with twine. Round bales more effectively shed rainfall, so they are better suited for outside storage. They are handled by large picks (spears) mounted on trucks, tractors, or loaders. Large bales are easier to load on trucks for shipping and can be fed to livestock with minimal labor.

It is not uncommon to have a part or all of the alfalfa harvesting done by a custom operator. The fee is either a specific amount per bale or a share of the hay crop.

If the alfalfa is to be stacked, the windrows are collected into small stacks, or swept and then stacked into large stacks. The stacks are left in the field and moved to the feeding area as needed.

Many farmers enter into a contract with a local dehydration plant to harvest their alfalfa. The alfalfa is chopped and hauled to the dehydration plant, where it is dried and processed. The dehydrated alfalfa is mixed with other ingredients for livestock feed. This method eliminates the need for haying equipment, since the dehydration plant usually performs all of the harvesting operations.

Marketing (Alfalfa)

Alfalfa hay is marketed or disposed of by any or all of the following methods:

1. Selling the baled alfalfa to livestock producers
2. Contracting with a local dehydration plant
3. Feeding the alfalfa to the farmer's own livestock.

Alfalfa hay is typically sold by the ton to both livestock producers and commercial or cooperative dehydration plants.

Basic Examination Techniques

Basic Farm Records

Like other business people, farmers are required to keep records which will enable them to file an accurate income tax return. The typical farmer's records usually include cancelled checks, paid bills, and a farm income and expense book. Farmers may have a formalized accounting system that may be computerized, making the records easy to follow and verify, but like many other taxpayers, some farmers do not keep good books and records.

Remember, although you need to try and work with whatever the farmer can provide, you are not required to accept a conglomeration of the farmer's records and put a set of books together. Always make it a point to shift as much of the burden to the farmer as possible for collecting and separating records. If the situation warrants, the rules for issuing an inadequate records notice are as applicable to a farmer as to any other taxpayer.

Books and Records Needed

When you are conducting the pre-examination analysis, list the books and records you'll need at the beginning of the examination. As required, mail the focused Information Document Request (IDR) along with the appointment confirmation letter.

Document Request

All items you will need for your examination should be listed on your IDR. The types of records are discussed above.

Interview

You will want to interview the farmer and tour the farm site. How to prepare for these interviews are discussed below.

Initial Interview

Prior to the initial interview review the return(s) closely for context and patterns in the business operation. The initial interview is considered the most important part of a quality examination. During the initial interview, allow the farmer time to discuss himself or herself, family, farming operation, style of living, successes, failures, hobbies, financial history and sources of income, including those of other family members.

An effective way to secure a lot of information is through casual conversation. This will put the farmer at ease so he or she will feel comfortable with you. Any pertinent questions or comments designed to lead the farmer into a conversation about his or her personal situation will suffice. If casual conversation is not effective, you may want to follow your interview outline in order to secure the information needed. If you use the outline, use it only as an aid. Do not substitute the outline for original and spontaneous questions. If you adhere strictly to the interview outline, you will seriously handicap your flexibility in asking appropriate follow-up questions. Take notes during the interview. If the farmer says something that is contrary to what is reported on the return, your notes should be very specific.

After the interview, it is helpful to prepare a written summary of what transpired and the main points discussed. These notes should be made a part of your workpapers, and may prove beneficial in making decisions about the examination at a later date.

Remember to target the initial interview questions to the type of farm operation that is reported on the return. If, during the interview, the examiner determines that the type of farm operation reported on the filed return is incorrect, redirect the interview to the type of business that was being carried on during the year under examination.

Visual Inspection

For field examinations, the initial interview will normally be conducted at the farm site. If the initial appointment is with the farmer's representative, be sure to schedule a tour of the farm early in the examination. When you arrive at the farm, be observant of everything around you. What types of buildings, machinery, and vehicles are there? Is there livestock? If so, what kind? Do other people live on the farm, maybe parents or an older son or daughter? If so, the farmer might be farming with someone else.

All the things you see when first observing the farm may generate other questions that should be asked during the initial interview. As you take a tour of the farm after the initial interview, it might be a good time to ask any other questions that come to mind. For example, if you see forage equipment but the farmer does not have forage crops, question the farmer regarding custom work done for others.

Online Resources and Information

Set forth below are various websites that may be helpful in conducting farm examinations:

MOST states have a land grant university. The extension services maintained by these universities can be a source of regional rental rates, custom hires rates, historic prices etc. The USDA maintains a website with state and national partners which include information relating to extension services. At the [USDA State and National Partners site](#) you will find a United States map – click on the state you wish to research.

[Agriscap](#) maintains a website with links to seventy-nine United States and foreign college agricultural sites.

The [National Ag Law Center website](#) contains subject-based reading rooms which consist of electronic resources for agricultural law topics.

The [Center for Agricultural Law and Taxation website](#) is maintained by Iowa State University. This site is a source for agricultural law and taxation.

The University of Illinois maintains a website which is an archived repository of [Farm Income Tax Schools texts](#). It is easily researchable and contains information beyond agriculture issues.

The [USDA National Agriculture Statistics Service website](#) provides useful US Agriculture statistics.

Employment Taxes

Internal Revenue Manual (IRM) 4.10.5

Required Filing Checks - Employment Taxes

Farmers that file Schedule F returns or corporate income tax returns may also be required to file returns for compensation paid to individuals for services. The additional returns include:

- Form 943, Employers Annual Tax Return for Agricultural Employees;
- Form 940, Employers Annual Federal Unemployment Tax Return;
- Form 1099, Information Return; and
- Form 945, Annual Return of Withheld Federal Income Tax.

The type of return required depends on whether there is an employer-employee relationship, or the farmer hires an independent contractor. For an in-depth discussion on determining employment status, refer to the training material “Independent Contractor or Employee?” Training 3320-102 (Rev. 10/96) TPDS 84238I.

Form 943, Employers Annual Tax Return for Agricultural Employees

Farm employers report wages paid to employees and the employment taxes attributable to those wages, on Form 943. Unlike the Form 941, Quarterly Employment Tax Return, required from non-farm employers, Form 943 is filed annually and is due on or before January 31st of the year following the year covered by the return.

Social security taxes, Medicare taxes, and income tax withholding apply to all cash wages paid to employees for farm work. A farmer is liable for these employment taxes if there are one or more agricultural employees, including a spouse, parents, or children age 18 or over, and if one of two of the following conditions is met:

1. The farmer has paid the employee \$150 or more in cash wages during the calendar year, or,
2. The farmer has paid at least \$2,500 in total wages for all farm labor during the year.

There is an exception to the above conditions. Wages paid to a seasonal farm worker, who receives less than \$150 in annual cash wages, are not subject to employment taxes, even if the farmer-employer pays \$2,500 or more in that year to all farm workers, if the farm worker:

- Is employed as a hand-harvest laborer (for example, fruit and vegetable pickers)

- Is paid by the piece in an operation that is usually paid on a piece-rate basis in the region of employment
- Commutes daily from his or her home to the farm
- Was employed in agriculture less than 13 weeks in the preceding calendar year.

However, wages paid to these workers are used in considering the \$2,500 or more test, for determining the employment tax coverage of other farm workers.

A farmer may employ a crew leader who provides workers and pays their wages for the agricultural services performed. If there is no written agreement specifying that the crew leader is the farmer's employee, and the crew leader pays the farm workers on his or her own behalf or on behalf of the farmer, then the crew leader, rather than the farmer, is the employer and is responsible for withholding and paying the employment taxes on the workers' wages.

Law Changes and Potential Examination Issues

Several changes were made to the social security payment requirements with respect to farm employment as of January 1, 1988. The income tax withholding requirements were also changed with regard to cash wage payments made after December 31, 1989. Changes and potential issues could arise if the farmer is following the employment tax rules in effect before these dates.

- Income tax withholding became mandatory for cash wages paid to farm employees after December 31, 1989. Before that, income tax withholding was voluntary, and by agreement between the employee and farmer.
- Wages paid to a farmer's children, aged 18 and above, for agricultural services are subject to social security taxes beginning with payments made after December 31, 1987. Prior to this a farmer's children had to be age 21 or above before social security tax applied to their wages.
- Any wage payments to a spouse are subject to social security taxes beginning with payments received after December 31, 1987. Before this, wages to a spouse were exempt from social security tax.
- Before January 1, 1988, a farmer was subject to social security taxes for cash wages paid to an employee who performed farm-related services on 20 or more days during the year. This requirement was replaced by the \$2,500 total wage test for determining if there is a social security tax liability.

Treatment of Non-Cash Wages

The 1950 amendments to the Social Security Act brought agricultural labor under social security coverage. The amendment included an exemption for non-cash wages. In defining wages for purposes of employment taxes, IRC section 3121(a)(8)(A) provides an exclusion for payments paid in any medium, other than cash, for agricultural labor. Cash

payments include checks and other monetary media of exchange, but do not include payments in the form of food, farm products, or other goods and commodities.

The regulations provide no guidance or examples of when payments in commodities for agricultural labor might be considered the same as cash and, therefore, not qualified for the exclusion from employment taxes. Consequently, an increasing number of farmers, particularly farm corporations, pay their officers and shareholders in grain or livestock. The result is the avoidance of social security and unemployment taxes even though the products are often sold for cash a short time after the commodities are transferred to the employee.

Whether putative non-cash payments are in substance, equivalent to cash payments has become a contentious issue. The “substance over form” analysis is inherently factual, and each case should be evaluated on its own facts. In a market segment understanding (Full text at Appendix B, General Livestock chapter), the Service has identified six factors for use in determining whether a bona fide transfer of a noncash medium has occurred. These factors are as follows:

- Existence and extent of documentation;
- Marketing and negotiation of a subsequent sale of the commodity by the employee;
- Shifting the risk of gain or loss to the employee;
- The length of time between the employee's receipt and sale of the commodity;
- Bearing the costs incident to the ownership; and
- Ready identifiability of the transferred commodity.

In addition, compensation arrangements under which virtually all of employee compensation is paid in commodities should be scrutinized carefully. Because some cash is necessary to meet the expenses of everyday life, this type of payment is often equivalent to cash.

Examples of farm employment agreements examiners may encounter in which wages are being paid in commodities, include:

- The farmer computes the number of hours the employee worked at an hourly wage, converts the amount owed into a specific amount of commodities, and pays that amount in commodities;
- The farmer pays the employee a fixed amount of grain or fixed number of livestock for the services performed;
- The farmer pays the employee based on a percentage of the crop or livestock produced. This is known as share cropping; and
- The farmer pays the employee in both cash and commodities.

Examiners must consider a number of facts in determining whether the IRC section 3121(a)(8)(A) exclusion from wages for in-kind commodity payments applies, when examining farmers who are paying employees this way. This is especially true of those

who operate in corporate form and pay a substantial portion of officer salaries in the form of commodities. Facts which should be developed include the following.

- Obtain a copy of the written employment contract (if any). If the agreement was oral, obtain a complete explanation of the terms. Any deviations in payment or computation of wage amounts, from those specified in the employment agreement, should be fully documented
- Determine whether the payment in commodities was a fixed amount, a percentage of total production, or based on a formula where the number of hours worked and an hourly wage were considered. Was the amount determined before or after the harvest or the sale of the farmer-employer's crop? Was the employee allowed cash advances or distributions against future sale proceeds?
- Determine how and when the employee was to take possession of the commodity compensation. Was the commodity separated from or commingled with the farmer-employer's commodities until sale? What costs did the employee incur after receiving the commodities as wages?
- Determine when the employee converted the commodity to cash. How long was the commodity held before conversion? Did the employee deliver the commodities to the market? Were the commodities delivered with and sold at the same time as the employer-farmer's commodities? Were they sold separately? Did the purchaser treat the employee's commodity as a separate transaction? Did the employee receive payment from the purchaser or did the farmer-employer provide the payment?
- Were in-kind wage payments available to all employees, or only to officers or shareholders? What is the farmer-employer's history of paying wages in cash versus in commodities? Are commodity payments available only to family members, (owner-employees in the case of corporations) for the purpose of avoiding employment taxes?

Examples of Non-cash Wage Agreements

Any agreement as to a specific dollar quantity of commodities, establishing a quantity of the commodity used for payment at the time of sale, will be considered to be an agreement for the payment of cash. Thus, the payment will not be excepted from “wages” for employment tax purposes.

There have been no court decisions regarding the issue of noncash compensation. A number of National Office Technical Advice Memorandums and one Revenue Ruling have been issued, providing examples of farmers using noncash wage agreements with employees, and the IRS's position regarding those facts and circumstances. Refer to the following ruling if you encounter this issue:

Rev. Rul. 79-207, CB 1979-2, 351

The facts and circumstances of each case must be considered. Where the facts indicate the economic substance of the transaction was to pay the employee in cash, and the

payment of commodities as wages was for the purpose of avoiding social security taxes, an employment tax issue should be raised.

Self-Employment Tax Attributable To Compensation in Commodities

In those cases where the officer/shareholder and/or other employee(s) are receiving a percentage share of the commodities produced on the farm, an alternative position could be raised on the employee's return by the imposition of self-employment tax. This would negate the overall tax benefit intended by the farmer under examination. This issue is based on the stated language in the employment and self-employment tax statutes. There are no regulations, rulings, or court cases to support or preclude this issue.

IRC section 3121(b)(16) excludes from the definition of employment: “service performed by an individual under an arrangement with the owner or tenant of land pursuant to which

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- A. such individual undertakes to produce agricultural or horticultural commodities (including livestock ***) on such land,
- B. the *** commodities produced by such individual, or the proceeds there from, are to be divided between such individual and such owner or tenant, and
- C. the amount of such individual's share depends on the amount of *** commodities produced;”

An individual who has a share cropping arrangement is thus statutorily excluded from being an employee irrespective of it if that person is an employee or an independent contractor. If there is no employment, then there are no “wages” under IRC section 3121(a).

IRC section 1402(a) provides that income from any trade or business is net earnings from self-employment and thus subject to self-employment tax. Being an employee is considered a trade or business so that IRC section 1402(c)(2) excludes services by an individual as an employee from self-employment income. However, subparagraph (B) then excludes “services described in section 3121(b)(16)” from the definition of employee services that are being excluded.

The income from the share cropping arrangement is thus statutorily included as self-employment income. Arguments about whether the person is an employee or contractor should be moot.

Filing Return and Depositing Tax

Effective January 1, 1993, new rules were established for determining when a farmer-employer must deposit social security and income withholding taxes, although the old deposit rules could continue to be used for the 1993 calendar year. For calendar years

after 1993, the new deposit rules must be used. If employment taxes of \$100,000 or more should accumulate at any time during the year, then the 1 day deposit rule applies. If total taxes paid during a look back period were \$50,000 or less, monthly deposits must be made. If total taxes paid in the look back period were more than \$50,000, semiweekly deposits are required. Circular A, Agricultural Employer's Tax Guide provides a complete explanation of the deposit requirements.

Form 940, Employers Annual Federal Unemployment Tax Return

Farmer-employers who pay cash wages must pay Federal unemployment tax (FUTA), if either of the following tests is met:

1. The farmer pays cash wages of \$20,000 or more to farm employees in any calendar quarter during the current or preceding year, or,
2. The farmer employs 10 or more employees for some part of at least 1 day during each of 20 different calendar weeks in the current or preceding year.

As with social security tax, unemployment tax applies only to cash wages paid to farm employees. IRC section 3306(b)(11) provides that “wages” do not include remuneration paid for agricultural labor in any medium other than cash for purposes of FUTA. See the previous discussion for when payments other than cash are considered the same as cash.

Farm workers provided by a crew leader are considered employees of the farmer for purposes of FUTA unless:

1. The crew leader is registered under the Migrant and Seasonal Agricultural Worker Protection Act, or
2. Substantially all the workers supplied by the crew leader operate or maintain tractors, harvesting or crop dusting machines, or other machines supplied by the crew leader.

If the farmer-employer is subject to FUTA, Form 940 must be filed by January 31 of the year following the calendar year for which the tax is due. When the amount of tax due is more than \$500 for the quarter, the tax must be deposited by the end of the month following the close of the quarter. If the amount of tax due is less than \$500, no deposit is required, but the tax must be added to the amount subject to deposit for the next quarter. If the total tax due for the year is less than \$500, it may be paid when the Form 940 is filed.

Form 1099, Information Returns

When a farmer makes reportable payments of \$600 or more during a calendar year for business purposes to an individual, Form 1099 must be filed to report these payments. Information returns are not required if the payments are made to a corporation.

Reportable payments include interest, rent, royalties, commissions, and nonemployee compensation. If a contractor (who is not a dealer in supplies) performs services for which he or she also provides the supplies needed, the farmer must report the entire payment for supplies and services on the Form 1099 issued to the contractor. Payments for trucking grain and livestock are excluded from the Form 1099 filing requirements (Treas. Reg. section 1.6041-3).

Payments reportable on Forms 1099 are generally not subject to FICA and income tax withholding. If the individual receiving payment does not provide the farmer with a valid social security number, the farmer is required to withhold 28 percent of the payments for income tax. This is called backup withholding. The farmer reports and pays backup withholding tax on Form 945, Annual Return of Withheld Federal Income Tax. Backup withholding deposits must be deposited separately from other payroll taxes. The deposit rules are basically the same as those previously discussed for payroll taxes, but the “Form 945” box on the Federal Tax Deposit Coupon (Form 8109) should be checked. If the farmer cannot document having the payee's social security number at the time the payments were made, backup withholding would apply if total payments were \$600 or more.

The farmer must give a copy of the Form 1099 to each person to whom payment was made by January 31 of the year following the calendar year in which the payment is made, and file it with the IRS on or before February 28 following the end of the calendar year in which the payments are made. Examples of individuals to whom farmers should issue Forms 1099 include: veterinarians, attorneys, accountants, mechanics, custom harvesters and chemical applicators who provide their own equipment, and land owners.

In examining a farmer's Form 1099 filing requirements, procedures that should be considered include:

- Obtain PMFOL (Payor Master File) transcripts to determine if the farmer has filed Forms 1099.
- Inspect Forms 1099 to determine if the farmer obtained social security numbers.
- Inspect Forms W-9, or any documentation maintained by the farmer, to show that the farmer obtained social security numbers before making payments.
- Review expense accounts such as labor, machine hire, legal fees, rent, and interest for payments to individuals who were not issued Forms 1099. If social security numbers were not obtained, backup withholding would apply.
- Inspect CP 2100 notices issued to the farmer by the service center, giving notification of incorrect social security numbers for Forms 1099 filed. If the farmer made no attempt to obtain correct numbers, backup withholding may apply.

Compensation to Spouse or Family Members

Reasonable wages or other compensation paid to the farmer's spouse or children for doing farm work is deductible, but the farmer must be able to show that a true employer-

employee relationship exists (Rev. Rul. 72-23). Ordinarily, an employment relationship is present if:

- Substantial duties are performed;
- The amount of pay is reasonable in relation to the work performed; and
- Payment is actually made.

Wages paid to a farmer's children are deductible even if the children use the money to buy clothes or other necessities which the parent would otherwise be obligated to provide (Rev. Rul. 73-393). This ruling should be considered any time a farmer is deducting as wages an amount paid other than by cash. If it can be determined that the item(s) given to the child in lieu of cash are what a parent would normally be expected to furnish, then the wages would not be deductible as labor expense. This rule is applied because providing such items in kind cannot be distinguished from the discharge of the parent's duty of support. More and more farmers are paying wages to their spouses to obtain various tax benefits such as 100 percent deductibility of health insurance, allowance of an IRA deduction for the spouse, and a reduction in the farmer's self-employment tax. Be sure there is a legitimate employer-employee relationship if the farmer deducts wages paid to a spouse.

Examination Techniques

During the initial interview establish the number of children the farmer has, their ages, whether they are at home or away, the number of vehicles and who drives them. Determine if the farmer has hired help other than his/her children and how their compensation is determined.

Non-cash wages

Non-cash wages include food, lodging, clothing, transportation passes, other goods and services. Non-cash wages paid to farm workers, including commodity wages, are not subject to social security or Medicare taxes. The value of non-cash wages is reported on Schedule F in income and as a wage deduction by the farmer (nets to zero as the non-cash wage has no basis). The value of non-cash wages is then reported on line 1 of the W-2 for the worker. When the worker sells the commodity, the sale is reported on Schedule D with the cost being the amount of wages reported on the W-2.

Farm Inventory

Basic Requirements

If a farmer is required to keep an inventory, a complete record of inventory should be kept as part of the farm records. This record should show the actual count or measurement of the inventory. It should also show all factors that enter into its valuation, including quality and weight, if applicable.

Accounting for Inventory

Generally, if a business produces, purchases, or sells merchandise, it is required to keep an inventory and use the accrual method of accounting for purchases and sales of merchandise. However, if a qualifying taxpayer or a qualifying small business taxpayer has an eligible business, the cash method of accounting can be used, even if merchandise is produced, purchased, or sold. If qualified, the taxpayer can choose not to keep an inventory, even if they do not change to the cash method of accounting.

A qualifying taxpayer is a taxpayer that for each prior tax year ending after December 16, 1998, has average annual gross receipts of \$1 million or less for the 3-tax-year period ending with that prior tax year. A tax shelter cannot be a qualifying taxpayer. See Publication 538 for more information.

A qualifying small business taxpayer¹ is a taxpayer that: (a) for each prior tax year ending after December 31, 2000, has average annual gross receipts of \$10 million or less for the 3-tax-year period ending with that prior tax year; and (b) whose principal business activity is not an ineligible activity. Certain other requirements must be met. See Publication 538 for more information.

¹Please be aware that the qualifying small business taxpayer exception does not apply to a farming business. However, if a qualifying small business taxpayer is engaged in a farming business, this exception may apply to their nonfarming businesses, if any.

Hatchery business - A hatchery business that uses the accrual method of accounting must include in inventory eggs in the process of incubation.

Products held for sale - All harvested and purchased farm products held for sale or for feed or seed, such as grain, hay, silage, concentrates, cotton, tobacco, etc., must be included in inventory.

Supplies - Supplies acquired for sale or that become a physical part of items held for sale must be included in inventory. Deduct the cost of supplies in the year used or consumed in operations. Do not include incidental supplies in inventory as these are deductible in the year of purchase. Supplies can be prepaid and consumed in the next year (Rev. Rul. 79-229).

Livestock - Livestock held primarily for sale must be included in inventory. Livestock held for draft, breeding, or dairy purposes can either be depreciated or included in inventory (See also Unit-livestock-price method). A taxpayer in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, must treat these animals as livestock for inventory purposes.

Growing crops - Generally, growing crops are not required to be included in inventory. However, if the crop has a preproductive period of more than 2 years, a taxpayer may

have to capitalize (or include in inventory) costs associated with the crop. See Uniform Capitalization Rules under IRC section 263A.

Items to include in inventory - Inventory should include all items held for sale, or for use as feed, seed, etc., whether raised or purchased, that are unsold at the end of the year.

Required to use accrual method - The following applies if the accrual method of accounting is required to be used.

- The uniform capitalization rules apply to all costs of raising a plant, even if the preproductive period of raising a plant is 2 years or less.
- The costs of animals are subject to the uniform capitalization rules.

Inventory Valuation Methods²

- Cost
- Lower of cost or market
- Farm-price method
- Unit-livestock-price method

² *If livestock inventory is valued at cost or the lower of cost or market, IRS approval to change to the unit-livestock-price method is not needed. However, if livestock inventory is valued using the farm-price method, then permission from the IRS must be obtained to change to the unit-livestock-price method.*

Cost method. The actual cost of each item or animal is used.

Lower of cost or market method. Compare the market value of each item on hand on the inventory date with its cost and use the lower of the two as its inventory value. Each item in inventory must be valued separately. Under ordinary circumstances for normal goods, market value means the usual bid price on the date of inventory. This price is based on the volume of merchandise normally purchased.

Farm-price method. Under this method, each item, whether raised or purchased, is valued at its market price less the direct cost of disposition. [Treas. Reg. § 1.471-6(d)] Market price is the current price at the nearest market in the quantities the farmer would normally sell. Where no open market exists, or where quotations are nominal due to inactive market conditions, the farmer must use such evidence as may be available for a fair market price at the date or dates nearest the inventory valuation (for example, grain and livestock price quotes in the newspaper). Cost of disposition includes broker's commissions, freight, hauling to market, and other marketing costs. When this method is used, it must be applied to the entire inventory, with the exception of livestock, which at the taxpayer's election may be valued using the unit-livestock-price method.

Unit-livestock-price method. This method recognizes the difficulty of establishing the exact costs of producing and raising each animal. Livestock is grouped or classified

according to kind and age, and a standard unit price is used for each animal within a class or group. The standard unit prices assigned must reasonably account for the normal costs incurred within such classes or groups. The classifications selected and the unit prices assigned is subject to approval by the IRS upon examination of the farmer's return. Once a return is examined and prices and classifications are approved, consistent application must be followed in all later years.

Annual reevaluation of unit livestock prices must be conducted and the prices adjusted upward or downward to reflect increases or decreases in the costs of raising livestock. IRS approval is not required for these adjustments. Any other changes in unit prices or classifications do require IRS approval.

A farmer who elects to use the unit-livestock-price method must apply it to all livestock raised, whether for sale, or for draft, breeding, or dairy purposes. Such method accounts only for an increase in the cost of raising an animal to maturity. It does not provide for any decrease in the market value of an animal after it reaches maturity. Hay grown by a farmer solely for feeding animals is not required to be inventoried.

All livestock purchased primarily for sale must also be included in inventory. Animals purchased for draft, breeding, dairy, or sporting purposes may be included in inventory, or subject to depreciation after maturity. If the livestock purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with established unit prices. However, in the year of purchase, do not increase the cost of any animal purchased during the last 6 months of the year. Animals purchased after maturity must be inventoried or capitalized at their purchase price.

A livestock producer who adopts a consistent unit-livestock method of valuing livestock inventories and files returns on that basis, will be considered as having elected the unit-livestock-price method. A farmer, who uses the cost, or lower-of-cost-or-market-method of inventory valuation for livestock, may adopt the unit-livestock-price method without formal application for permission. However, a change from the farm-price method to the unit-livestock-price method requires Commissioner approval. In addition, a change from the unit-livestock-price method to any other inventory valuation method requires formal approval.

Uniform capitalization rules. A farmer can determine costs required to be allocated under the uniform capitalization rules by using the farm-price or unit-livestock-price inventory method. This applies to any plant or animal, even if the farmer does not hold or treat the plant or animal as inventory property.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Income

Background

Income to the farmer consists primarily of sales of grain, livestock, produce, or other products of the farm. Other sources of farm income can include:

- Miscellaneous income from farm labor or custom work
- Government benefit checks
- Rents
- Royalties
- Other similar activities.

A farmer's sales generally fall into five classifications:

1. Stock in trade (livestock, grain, and other products of farming). Income from these sales ordinarily will be entered on page 1 of Schedule F.
2. IRC section 1231 assets (buildings, machinery & equipment, and livestock held for draft, dairy, breeding, etc.). Income from the sale of IRC section 1231 assets, and any corresponding IRC section 1245 gain, is initially entered on Form 4797. It is then carried to Schedule D or directly to page 1, Form 1040. Please refer to the "Sales of Livestock" chapter for a more detailed explanation.
3. Other property used in farming which does not meet the requirements for IRC section 1231 treatment (draft, breeding, dairy, or sporting animals held for less than the required period and other assets used in the business but held 1 year or less). Income from these sales will usually be reported in Part II of Form 4797.
4. Capital Assets (farmhouse, stocks and bonds, personal automobile, etc.). Gains from the sale of capital assets are usually reported directly on Schedule D, and are discussed in the "Basis and Sales of the Farm and Farm Assets" chapter.
5. Farm land, which is classified as an IRC section 1252 asset. The gain from a disposition of farm land is regulated by IRC section 1252. The tax treatment of sales under IRC section 1252 is similar to that under IRC section 1245.

The gross profit percentage for farming can be misleading since there is generally no income pattern among individual farmers. This is due to the variation in the size of farms, methods of marketing, etc. For example, if a farmer sells the current year's crop and part of last year's crop in the current year, this gives a distorted picture of current year receipts.

Many farmers now have an additional source of income from one or more family members working away from the farm. This area needs to be inspected for potential unreported income from contract labor or self-employment.

Be sure all income generated by the farm has been reported. Income includes not only cash received, but also the value of any merchandise or services received in exchange for farm products. Bartering income is taxable (Rev. Rul. 80-52).

Growing crops (inventory) are those that remain unharvested at the end of the taxable year. These include all cultivated plants grown for sale, feed, seed, and the farmer's own consumption.

The ultimate disposition of the growing crop, before or after harvest, typically results in ordinary income to the accrual basis farmer when the farmer is entitled to the income.

Sale of Crops and Produced Items

The farmer starts with the capital, land, buildings, and equipment, and adds to that the labor and raw materials necessary to produce the completed product. Raw materials could include fertilizer, seed, chemicals, feed, breeding animals, or any number of other items. Then, over some period of time, the product is “manufactured,” that is, raised until it becomes a completed product.

A Revenue Agent must determine that all products produced and sold have been included in income. The sale of all raised livestock, produce, grains, and other products are combined and reported on the same line of Schedule F.

When the farmer sells the crops raised on the farm, payment can be in the form of money, property or services (use fair market value (FMV) to determine income). Irrespective of the manner of payment, it is treated as ordinary income. The profit from the sale of any crops bought for resale is also ordinary income. The amounts received must be reported in income in the year received. The profit or loss from the sale of crops bought for resale is the difference between the basis in the crop purchased and any payment received.

The net proceeds from the sale of a crop by someone acting as the farmer's agent must be included in gross income for the year the agent receives payment, even though there is an arrangement with the agent that the farmer will not be paid until a later year

Example 1

Alice Chambers contracts with an agent, Dale Jenkins, to sell her corn to the local elevator on December 27, 2004. She asks Dale to remit the sales proceeds to her in January 2005, instead of in December 2004. Even though she received the funds in 2005, she must include the sale of the corn in her income in 2004.

Commission sale barns have been held to be agents for the seller.

A recent court case, *Scherbart v. Commissioner*, 453 F.3d 987, affirming T.C. Memo 2004-143, concluded that Mr. Scherbart could not defer “value added” payments from a co-op that were computed in November even though Mr. Scherbart was offered an option to defer the payment to January. The court concluded that there were no installment agreements, the co-op was an agent for Mr. Scherbart and Mr. Scherbart voluntarily deferred the payments.

See also Rev. Rul. 70-294, 1970-1 C.B. 13 and Rev. Rul. 79-379, 1979-2 C.B. 204.

When a crop is held and used for feed, it can be treated in one of two ways:

1. The income can be reported and an equal, offsetting feed expense shown
2. No crop income reported and no feed expense deducted.

In areas where the growing season is long, crops can be double cropped. Normally the two crops will include wheat and either soybeans or milo. Once the wheat (planted the previous fall) is harvested in June or July, the ground is immediately replanted into soybeans or milo.

The following is a compilation of the most common types of crops and the possible income sources from those crops.

Grain Crops

Wheat, Sorghum or Milo, Corn, Soybeans, and Oats are the grain crops discussed below.

Wheat

In the late fall and early winter, the wheat field may be rented out as pasture for cattle. This does not harm the harvest value. It can also be cut for hay in May, when it has just started to head out. When the wheat is cut for hay, it cannot be harvested. When the wheat is harvested, it can be sold immediately or stored and sold at some future date. The straw resulting from the harvest can be baled and sold.

Sorghum (Milo)

Milo can be sold when harvested or stored for a time before being sold. After harvest, the milo stalks (stubble) can be rented out as pasture for cattle in the fall after a hard frost. Milo can also be stored and used as feed for the farmer's livestock. Milo is a short season crop. It can be planted in the spring and harvested in the late summer or it can be double cropped, planted after the wheat is cut in June or July and harvested in the late fall.

Corn

Corn can be cut green and used as silage. If the corn is harvested, in the fall, it can be sold immediately or stored for future sale. It can also be stored and used as feed for livestock. After harvest, the corn stalks can be baled and sold as bedding or as fodder to cellulosic ethanol plants, or the corn stalk ground can be rented out as winter pasture for livestock.

Soybeans

Soybeans are normally harvested in the fall. They can be sold immediately or stored for later sale. Soybeans must be processed into meal before being fed to livestock. Soybean oil is extracted by processing. Some uses of the oil are in food preparation or in biodiesel production.

Oats

Oats are planted in the spring and harvested in late summer. They can be cut for hay when they have just started to head out. If oats are used for hay, they can't be harvested. When oats are harvested, they can be sold immediately or stored, then sold. Oats are often used in livestock feeds. Oat stubble, the plant stalk remaining in the field following harvest, can be baled and sold for livestock bedding.

Hay Crops

Hay crops are another source of income to the farmer. Generally once a field is planted to hay; it can be used for hay for many years without replanting. Alfalfa has a life of 4 to 5 years. Brome and prairie hay can be grown in the same field indefinitely.

Brome

Brome is usually cut once a year, from late spring to early summer. The hay is baled and can be fed to all types of livestock. The field can be used to pasture livestock in the fall.

Alfalfa

Alfalfa is a very high protein crop that is used as livestock feed. It can be cut and baled for hay, chopped into silage, or ground and compressed into pellets. Alfalfa is usually cut three to five times a year.

Prairie Hay

This hay consists of native grasses. It is normally cut and baled in the summer and used as feed for all livestock.

Constructive Receipt of Income versus Installment Sale Reporting Of Income

Installment Sales

Before the 1980 Installment Sales Revision Act took effect, if a farmer did not have a valid deferred payment contract, income from the sale of crops or livestock had to be reported in the year of sale (constructive receipt). The 1980 Act postponed reporting income on installment sales (one or more payments received after the year of sale) until the year in which the payment was received. This was true even without a valid deferred payment contract, as long as the seller did not receive evidence of any indebtedness that was payable on demand or readily tradable (IRC section 453(f)(4) & (5)).

A farmer must elect not to report income on the installment method before he or she will have constructive receipt of income. In other words, unless the farmer elects to report the

constructive receipt of income in the year of the sale, income from a sale (where any payment is to be received in a taxable year after the year of sale) is to be reported on the installment method.

Example 2

Janet Jasper delivered 12,000 bushels of her corn to the elevator on October 20, 2004, and signed a contract with the elevator that obligated the elevator to pay her \$2.55 per bushel for the corn on January 5, 2005. Under the contract, she was not allowed to sell, assign, transfer, pledge, or convey the contract or any of her rights in the contract.

Janet had no legal right to receive payment before January 5, 2005. Consequently, she is treated as receiving income on that date and, therefore, she reports the sale of the corn on her 2005 income tax return for both regular and AMT tax purposes.

Example 3

Connie Greene delivered 5,000 bushels of her corn to the elevator on October 1, 2004, and negotiated a sale price of \$3 per bushel. Before the elevator cut the check for the corn, Connie talked to Janet Jasper and decided that she should defer her payment until January 2005. Connie told the elevator to wait and send her check after January 1, 2005.

Connie had a legal right to receive her payment in 2004 and deferred receiving the check to 2005. Even though Connie could have received in 2004, if she does not elect out of installment reporting, she must report the income in 2005 for regular income tax and Alternative Minimum Tax (AMT) purposes. She may choose to elect out of installment reporting and report the income in 2004 for regular tax and AMT purposes.

The above example should be viewed with extreme caution. There may be state or local laws that negate the attempted deferral of income. For example, under Iowa law, a licensed grain dealer (the elevator) must pay the seller within 30 days of the date of sale. A mere request by Connie to receive her payment in January of 2005 for grain she sold in October 2004 to a licensed grain dealer could not be honored in Iowa. In Iowa, Connie would have to execute a deferred payment contract to achieve the desired deferral of income.

Constructive Receipt

Income, although not actually in the farmer's possession, is constructively received in the taxable year during which:

- It is credited to the farmer's account;
- Set apart for the farmer;
- Made available so the farmer can draw upon it at any time; or
- The farmer can draw upon it if notice of intent to withdraw was given.

For example, the receipt of a check is constructive receipt of funds, even though not deposited or cashed during the tax year received.

Income is not constructively received if the farmer's control of its receipt is subject to substantial limitations or restrictions.

Farmers often enter into contracts in which income derived is not received until a later taxable year. A number of rulings and court decisions have considered the correct year of income inclusion for cash basis farmers when farm commodities are sold under deferred payment contracts. The determination usually hinges on a bona fide contract entered into at arms-length, and the provision that the farmer cannot withdraw the proceeds under any circumstance until the following year. The courts have also looked at a taxpayer's past practices and whether or not income was materially distorted when selling commodities.

If any items are sold under a deferred payment contract that calls for payment(s) in the following year(s), there is no constructive receipt in the year of sale, Rev. Rul. 58-162.

Examination Techniques

Potential areas of abuse include:

- Checks received from the sale of livestock or crops in December, held and not deposited until January;
- Sales made on December 31, so that there is no way the check will be received until January; and
- Sales in which the agreement to defer payment occurs after the farmer obtains the right to receive payment.

The income tax requirements for income under the installment agreement method versus the constructive receipt method have not yet been resolved. This is shown in the conflict between the constructive receipt doctrine of Rev. Rul. 58-162 and Rev. Rul. 73-210, and the cash equivalency doctrine of *Watson v. Commissioner*, 613 F.2d 594 (5th Cir. 1980) and *Griffin v. Commissioner*, 73 T.C 933 (1980).

The significant issue is whether the constructive receipt or the cash equivalency doctrine was applied, because a farmer could use the installment method of reporting income even if the contract did not meet the deferred payment requirements.

Crop Shares

Crop shares are rental payments made to a farmer-landlord based on a percentage of the yield of the crop and usually payable in kind (Rev. Rul. 56-496).

The regulations state that crop share rents are to be treated as income by either a cash basis or an accrual basis farmer only when the shares are reduced to money or its

equivalent. Accrual basis farmers do not inventory crop share rents on hand at the end of the year.

If the landlord receives crop shares and uses them as feed in his or her farming operation, he or she must include the FMV of the crop shares in gross income. At the same time, under IRC section 162 the landlord will be entitled to a trade or business deduction for livestock feed equal to the value of crop shares included in gross income (Rev. Rul. 75-11).

If the farmer makes a gift or contribution of the crop shares, gross income must be recognized in an amount equal to the FMV of the crop shares at the time of the gift or donation, not when the crop shares are converted to cash or an equivalent by the receiver.

Crop share rental income is excluded from self-employment income unless the landlord materially participates in the production of agricultural products, or production management. The concept of material participation was developed to help distinguish why rents are treated as passive income, while income from farming is treated as self-employment income.

Material participation is necessary to build a social security base and may be necessary if current use valuation is to be used for Federal estate tax purposes. Material participation may cause social security payments to be decreased for persons eligible to receive such payments. Therefore, if crop shares are rents, self-employment tax does not apply. Because the crop shares are not classified as earned income, any amount of crop share income can be received without a reduction of current social security benefits.

Material Participation

Crop shares present a problem because some farmers are virtually in partnership with their tenants. In those circumstances, the income should be treated as if it were earned income from farming. In many of these situations, a formal partnership may not be found and certainly would not be desired by the parties involved. Therefore, the concept of material participation was developed. If a landowner materially participates with the tenant in making the decisions and paying some of the farming costs, the landowner is considered to be an active farmer rather than a passive landlord. His or her share of the crops thus would be characterized as farm income rather than rental income. This distinction was adopted by the Congress in 1956 and is now set out in the statute for Social Security purposes.

Examination Techniques

Areas of potential abuse arise when the following occurs.

1. Active income is classified as passive income.

2. Income earned by the farmer is reported by another family member(s) (normally a spouse or children). This is done so that social security payments will not be affected or reduced by earned income.

Use of Contracts to Defer Income Recognition

The farmer may attempt several methods to defer the reporting of income. Examples of allowable methods are holding the crop until the next year, or securing a Commodity Credit Corporation (CCC) loan which may not be income. For discussion on CCC loans, please see the “Commodity Credit Corporation Loans” section of the “Government Farm Programs” chapter.

A farmer may also try to find ways to sell products in the current tax year if the price is favorable, but delay inclusion of the income for tax purposes until the following year. Two types of contracts used to accomplish this are Deferred Product Sales and Price Later Contracts.

Deferred Product Sales

In 1980, Congress enacted the Installment Sales Revision Act of 1980, which amended IRC section 453. The change in the installment sales provisions opened a new method of income deferral for farmers besides deferred payment contracts, Rev. Rul 58-162.

IRC section 453(a) provides that income from an installment sale shall be taken into account under the installment method. IRC section 453(b)(1) defines an installment sale as receipt of at least one payment after the close of the taxable year in which the disposition occurs. The installment sale provisions are generally not available to dealers. However, a dealer disposition does not include the disposition on the installment plan of any property used or produced in the business of farming; therefore, farmers can sell on the installment basis (IRC section 453(b)(2)(A)).

You must determine if the farmer has made any such installment sales. Your concern on Schedule F is that all ordinary income items have been included in income. If the farmer has sold grain, livestock, or other products on the installment basis, there should be a contract stating the selling price and the dates payments are to be made. Ask for copies of such contracts to insure that the income is properly reported in the correct tax year.

Price Later Contracts (PLC)

A Price Later Contract (PLC) is for the sale of a product in which the title passes to the buyer upon delivery of the product. The PLC specifies a period (the pricing period) for fixing the purchase price of the grain, starting with the date of the PLC. On any business day during the pricing period, the farmer sets the price for his or her grain by selecting a price quoted by the buyer for similar grain, on that day.

IRC section 61 provides that gross income means income from whatever source derived, unless specifically excluded elsewhere in Treas. Reg. section 1.61-4(a) provides, in part, that a farmer using the cash receipts and disbursements method of accounting shall include in his or her gross income for the taxable year the amount of cash and the value of merchandise or other property received during the taxable year from the sale of produce which he or she raised. Treas. Reg. section 1.61-4(c) also provides additional rules for certain farm receipts.

IRC section 453 permits a taxpayer who sells real property and a nondealer who sells personal property to report gain on the installment method. IRC section 453(f) provides that receipt of a bond or other evidence of indebtedness which is payable on demand shall be treated as receipt of payment. There was some thought that use of a PLC would prevent the farmer from availing himself of the installment sale provisions of IRC section 453. See Calvin P. Applegate, 94 T.C. 696 (1990), *aff'd*, 980 F.2d 1125 (7th Cir. 1992) (contracts were not obligations payable on demand).

A farmer executing a price later contract who wishes to effectively defer income should incorporate an income deferral provision into the PLC so that even if the price is set during the tax year the income is deferred.

Distributions from Cooperatives

A cooperative (co-op) is an enterprise owned by and operated for the benefit of those using its services. Farm co-ops can provide a wide selection of services to the farmer. These include selling the farmer's crop and purchasing products for the farmer's use. Commonly, the items purchased are needed for the farm, such as, seed, fertilizer, and equipment, but they may include personal items as well.

Cooperatives have changed in recent years through consolidations and mergers. The needs of farmers have changed and the cooperatives have kept pace with the member needs. Many cooperatives provide a multitude of agronomy services to aid farmers in precision farming and value added products.

One of the latest means by which cooperatives in the grain belt have served member needs is to set up separate companies that build large grain storage and handling facilities, generally on co-op land. Co-op members are allowed to purchase "grain condos". While this arrangement shifts responsibility for grain quality to the co-op, the farmer retains beneficial ownership of the grain for purposes of Agricultural Program Payments. Ownership of the "condo" could generate allowable depreciation expense for the farmer.

Note: Many rural areas also have utility cooperatives, which may also be a source of expenses and dividends for farmers, especially since many rural electric cooperatives are looking to alternative methods for electricity generation.

Patronage Dividends

Co-ops operate at cost. That is, farm co-ops return to farms the net profits from the cooperative business in proportion to the amount of business conducted by each farmer.

Usually, the rebate of the co-op business profits to the farmer is a patronage dividend, deductible by the co-op and included in the income of the farmer. This patronage dividend may be paid in the form of money, property, or scrip. The amount of money, the fair market value of the property, or the face value of the scrip is included in the income of the farmer.

The scrip paid to farmers is usually in the form of a written notice of allocation or a per-unit retain certificate, evidencing an obligation from the cooperative to the farmer. An important consideration is whether this scrip is qualified or nonqualified. A qualified written notice of allocation or a qualified per-unit retain certificate is one that the farmer has consented to include in his or her income upon its receipt.

These same forms of scrip are not included in the farmer's income when issued in nonqualified form. The issuance of nonqualifying scrip is not a patronage dividend taxable to the farmer. Rather, the amounts paid to redeem nonqualified written notices of allocation or nonqualified per-unit retain certificates will be included in the farmer's income upon redemption.

Patronage dividends are reported to the farmer on Form 1099-PATR. The patronage dividends should be reported on the farmer's return for the year in which they are received. Patronage dividends usually are subject to self-employment tax. However, patronage dividends received in crop share arrangements are reported on line 2 of Form 4835 and are not subject to self-employment tax.

There are two exceptions to the inclusion of the patronage dividends in the farmer's income, other than the rule applicable to scrip issued in nonqualified form.

1. First, amounts received with respect to purchases of supplies, equipment, or services which were not intended for use in a trade or business or an IRC section 212 activity are not included in the farmer's income. In some instances, an allocation must be made for this purpose. For example, where gasoline is purchased from a cooperative for both farm and personal use.
2. Second, amounts properly taken into account as an adjustment to the basis of property are not included in the farmer's income. For example, where equipment is purchased and a dividend is paid for that specific purchase.

Other Receipts

Amounts received by farmers other than patronage dividends are treated under other tax rules. Such amounts might be taxable as compensation for services, dividends on stock, or interest on loans, or such amounts might be nontaxable, as in the case of a return of capital.

All cooperatives provide for a discounted redemption from the estate of a deceased patron. Discount charts are calculated based on the value of borrowed funds and the age of the certificates. If desired, the heirs of a former patron may elect to have an immediate redemption of all certificates owned by the estate at these discounted values. Such redemptions give rise to an ordinary loss to the farmer in the amount of the discount. See Rev. Rul. 70-407, 1970-2 C.B. 52. Otherwise, the certificates will be redeemed as authorized by the board.

Examination Techniques

Often the farmer reports patronage dividends on the tax return erroneously in one of two ways.

1. The farmer reports the dividends on the front of Form 1040 as dividend income. By reporting the dividends in this manner, the farmer avoids self-employment tax on this income.
2. The farmer only reports the amount of patronage dividends received in cash. The dividend should include the fair market value of other property received as patronage dividends, such as stock, the face value of qualified scrip issued to the farmer, and amounts received in redemption of previously issued nonqualified scrip.

Easements and Rights-Of-Way

Income received by farmers to grant easements or rights-of-way on their property for flooding land, laying pipelines, or constructing electric and telephone lines, etc., may result in income, a reduction of all or part of the basis of the property, or both.

Example 5

Fred Falls sold a right-of-way for a gas pipeline through his property for \$1,000. Only a specific part of his farmland was affected. He reserved the right to continue farming the surface land after the pipe was laid.

1. If the \$1,000 received for the right-of-way is less than the basis of the property allocated to the portion of land affected by the right-of-way, then the basis is reduced by \$1,000.
2. If the amount received is more than the basis of the affected portion of the land, the excess is gain from the sale of IRC section 1231 property.
3. If, instead of selling a right-of-way, he sold part of his land, he would have a gain or loss from the sale of IRC section 1231 property.
4. If during construction of the line, growing crops were damaged and he later received a settlement of \$250 for this damage, then the \$250 he received in damages is income. This income is reported on Schedule F just as the crop sale would be.

Easements and rights-of-way will normally be split between permanent damages and crop damages. There should be a signed document indicating the amount of permanent damages and the amount of crop damages.

Other Farm Income

The majority of farm income is derived from sales of products and Government payments. Some of the more common sources of other farm income include fuel tax credits and refunds, machine work, and commodity futures transactions (hedging). These items are discussed in later chapters.

Machine Work

Machine work is work performed by the farmer or the hired help on someone else's farm (it should be noted that machine work and custom hire are generally synonymous). The farmer might contract with another farmer to do such work as combining, cutting or baling hay, spreading fertilizer or to allow the use of equipment by another farmer. The farmer may be paid in cash, check, services, or merchandise. This income is taxable, but you will not always find it reported on Schedule F as required.

Hedging Farm Commodities

Hedging Transactions - Defined

Hedging is a common technique used by businesses to manage the risk of interest rate changes, price changes, or currency fluctuations, with respect to borrowings, ordinary property or ordinary obligations. Various financial products, such as futures contracts, forward contracts, options on futures, and notional principal contracts, are used to reduce risk. Farmers, cattle feeders, and feedlots generally enter into hedging transactions to reduce the risk of price changes with respect to inventory and non-inventory supplies. They also can buy and sell commodity futures as speculators. The principal matter of concern from an income tax perspective in the farm and ranch area is the line between hedging and speculation.

Property is ordinary property only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period. For example, property used in a trade or business within the meaning of IRC section 1231(b) is not ordinary property because the gain resulting from the sale or exchange of the IRC section 1231 asset may be treated as capital. The same applies for non-inventory supplies such as corn used to feed cattle, since gain or loss from the sale of such property is capital. However, the Code provides an exception in situations where supplies are consumed rather than sold. Specifically, IRC section 1221(a)(8) provides supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer are not considered capital assets. Thus, consumable supplies

receive ordinary gain or loss treatment and a long futures position hedging a cattle feeder's supply of corn may qualify as a hedging transaction under the Code.

A taxpayer is not required to hedge its entire risk. Instead, transactions hedging a portion of a taxpayer's risk may qualify as a hedging transaction under the Regulations. Examiners should focus on whether a transaction reduces a type of risk enumerated in the Regulations. It is appropriate for an examiner to consider whether a taxpayer is over-hedged. To the extent the taxpayer is over-hedged, it is not reducing risk, and, therefore, the transaction does not qualify as a hedging transaction under the Regulations.

These Regulations are the exclusive means by which gain or loss from a hedging transaction qualifies as ordinary gain or loss. (Treas. Reg. Section 1.1221-2(a)(3)) Consequently, prior case law is irrelevant in determining whether a taxpayer was hedging.

A forward contract is a non-exchange traded agreement between two parties to buy or sell a specified quantity of a commodity at the current price for delivery or settlement at a specified future date. A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount and quality of a commodity at a future date for a fixed price.

Businesses may enter into commodity futures contracts or forward contracts and may acquire options on commodity futures contracts as either of the following:

- Hedging transactions; and
- Transactions that are not hedging transactions (Speculative Ventures).

Gain or loss from such transactions will qualify as ordinary gain or loss only if it satisfies the definition of a hedging transaction. IRC section 1221(b)(2)(A) defines a hedging transaction as a transaction entered into in the normal course of the taxpayer's trade or business primarily to reduce the risk of price changes, interest rate changes or currency fluctuations. Commodity futures gains and losses that do not qualify as hedges and that do not involve contracts primarily for sale to customers in the ordinary course of a trade or business are treated as capital gains and losses.

If a farmer enters into commodity forward contracts, futures contracts or options on futures contracts to protect himself/herself from the risk of unfavorable price fluctuations, and the contracts cover an amount of the commodity within their range of production, the transactions are generally considered hedging transactions. They can take place at any time the farmer has the commodity under production, on hand for sale or reasonably expect to have it on hand. There can be an "anticipatory" hedge with respect to a hedge of a change in price on goods to be acquired or sold.

Courts emphasize two tests in evaluating commodity futures transactions as hedges or as speculative ventures:

Direct Relation Test

- There must be a direct relation between the taxpayer's business and the commodity market transaction if the transaction is to be considered a hedge.
- The direct relation test requires that the amount of futures trading in the commodity involved and the timing of the purchases and sales must be related to the position the taxpayer is actually in. Thus, where the amount of futures trading exceeds substantially more bushels or number of head needed to provide price protection for actual bushels or number of head the farmer has or expects to have or the pattern of purchases and sales in futures is not consistent with securing price protection for the farmer's actual business activity, the transactions are likely to be treated as speculative rather than hedges. Each instance is a facts and circumstances determination.

Insurance Test

- If futures' trading is used to offset price changes in actual commodities, the futures transactions are hedging.
- If the commodity transactions are an integral part of the taxpayer's business where the futures contracts are used as price insurance against subsequent price increases with respect to needed raw materials or price decreases for production to be sold, then they are considered to be a hedge.

Identification Rules

Treasury Regulation section 1.1221-2(f) states that in order to receive ordinary loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged.

- Hedging transactions must be clearly identified in the books and records before the close of the day on which the taxpayer enters into the hedge.
- The hedged items or aggregate risk must be identified within 35 days after entering the hedging transactions.
- The identification must be made on, and retained as a part of, the taxpayer's books and records and must specify the hedging transaction and what is being hedged.
- The presence or absence of identification must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement, unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. Treasury Regulation section 1.1221-2(f)(4).

If a transaction is a hedge, but is not identified as a hedge in the books and records, the gains are ordinary and losses are capital. Furthermore, if a transaction is identified as a hedging transaction, but is not a hedge, the gains are ordinary, but the losses may be capital.

Marketing Tools Used To Protect the Price of a Commodity

The Futures Market

There are various market tools that can be used to protect the price of a commodity. The futures market is used frequently because it offers actual futures contracts and futures options. The most popular are the actual futures. Futures contracts have the highest risk of loss and are more expensive than options. Also, futures require margin money to be deposited. Margin money is cash or equivalent required to guarantee fulfillment of a futures contract.

Futures options can provide the same price insurance and are much less expensive. There are two kinds of options: Puts and Calls. Both can be bought or sold by anyone. A put is an option giving the holder the right, but not the obligation, to sell short a commodity futures contract. A call is an option giving the holder the right, but not the obligation, to purchase a futures contract. The buyer has a choice of whether or not to exercise an option. The seller of a put option is obligated to buy the underlying futures contract and the seller of a call option is obligated to sell the underlying futures should the buyer exercise the option. Generally there is no margin money required for owners of options because the cost of the option (premium) is paid up front; however, sellers of puts and calls are required to maintain margins in their accounts.

The Options Market

The options market is gaining popularity because of the reduced risk. But the temptation to speculate is present, the same as in actual futures contracts. Hedgers should buy only enough options to cover their actual or expected positions in the cash market. Options are offered in the same months that the underlying futures contracts are offered. They expire 1 month prior to the actual futures, except for feeder cattle options which expire in the same month as the futures contract. For example, an October live cattle put option would expire in September instead of October when the futures contract expires; whereas, an October feeder cattle option would expire in October. When an option is sold, the seller is paid a premium. The premium is not collected until the option is exercised or expires. The seller of an option is required to pay margin money to cover any possible losses. This is because the seller is at risk and will lose money if the purchaser exercises the option. The purchaser will only exercise the option if he or she can make a profit. If that happens, the seller will suffer an offsetting loss.

Buying calls provides protection against rising prices. These transactions allow a person to limit the amount paid for replacement inventory. Buying a put provides protection against declining prices. A person can guarantee the price at which a product eventually will be sold. Thus, put and call options provide the same kind of price protection provided with long and short positions in the futures markets.

As with actual futures contracts, a hedger should purchase only the number of options necessary to cover the cash market (actual or expected) position. Any excess is over hedging and to the extent the taxpayer is over hedged, there is no reduction of risk and the transaction does not qualify as a hedging transaction.

Hedging Cattle

Futures and options are offered for live cattle and feeder cattle. Live cattle contracts can only be used to hedge mature cattle sold or purchased. They are also referred to as fat cattle. A live cattle contract represents 40,000 pounds. To determine the number of head a contract represents, you will need to know at what weight the taxpayer sells its cattle. For example, if the cattle are fattened to an average weight of 1,250 pounds, a contract would represent 32 head ($40,000 / 1,250$). If the cattle are marketed at 1,100 pounds the contract would cover 36 head ($40,000 / 1,100$). This computation is necessary to determine if the taxpayer is over hedged. A producer places a hedge by entering into the correct number of futures contract(s) to sell feeder cattle or, by purchasing the correct number of put options to sell the same number of feeder cattle future contracts.

Feeder cattle contracts are used to hedge replacement cattle for feedlots. The contracts are for 50,000 pounds of cattle. If feeder cattle are to be purchased in the future, the taxpayer will need to go long in the market. This means that feeder cattle contracts or call options will be purchased. Again, it is important to determine how many head will be covered by a contract. In the feeder cattle market, ranchers maintain breeding herds that produce the cattle. These ranchers hedge their finished product by selling feeder cattle contracts or by purchasing put options on feeders. Related to the feeder cattle industry are taxpayers who purchase small cattle and place them in starter feedlots. These cattle are later sold to other cattlemen who also place them in feedlots. These taxpayers could be entering into futures contracts to both buy and sell feeder cattle. They would enter futures contracts to buy feeder cattle to hedge calves to be purchased for their feedlots and enter futures contracts to sell feeder cattle to hedge the price of those calves when they are ready for sale.

Hedging Grain Crops

Futures and options are used for growing grain crops and for hedging purchased grain used for feeding cattle or for resale by grain dealers. The same rules and techniques will apply to grain as to those for cattle. Grain farmers normally do not purchase grain, they only sell it. Most farmers have patterns of grain selling. Some sell near harvest time each year and many sell at year end or carry grain over and sell in January. This is important to know because the producer should generally use the correct futures month. If a farmer normally sells wheat in December, then December wheat futures should be used; however, this is not always necessary to be a valid hedge.

Be aware that farmers sometimes sell grain using deferred payment contracts. They deliver grain to the elevator and then contract with the elevator to receive a fixed or pre-agreed price in the following year, usually January. In this situation, there is no need for

price protection because the price is already set. Any dealings in the futures market for that particular lot (number of bushels contracted on the deferred payment contract) would not reduce risk and, therefore, would not qualify as a hedging transaction under the regulations.

Transaction Analysis

Hedging issues often result in unagreed cases. An unagreed case will require a detailed analysis of the farmer's trading accounts. Each transaction will have to be listed, and the workpapers need to reflect:

- Date entered;
- Position (long/short);
- Commodity identification;
- Trading price;
- Date closed;
- Settlement price; and
- Gain/loss.

Sometimes it is difficult to trace the transactions from start to finish. It is almost impossible to do this without the daily trade confirmation sheets, because they include all the identifying details.

A good way to check the accuracy is to look at open positions listed on the month end reports. If a contract is still shown as open and the report fails to show it, go back and find when it was closed. Compare the contracts shown as open at the end of the month with those shown in open status on the broker's month end summaries.

Accounting Methods for Hedging Transactions

A taxpayer may choose any accounting method for a hedging transaction that clearly reflects income and may use different methods for different types of hedging transactions. The accounting method must reasonably match the timing of income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. (Note: Treasury Regulation section 1.446-4(e) for the requirements and limitations on the method that can be used for certain hedging transactions)

The Service and Treasury expect that the hedge accounting methods employed by most taxpayers for financial accounting purposes will satisfy the clear reflection standard in the Regulations. However, the method chosen must be used consistently and be changed only with the consent of the Commissioner. (Treasury Regulation section 1.446-4(c)).

The Regulations require taxpayers to maintain books and records containing a description of the accounting method used for each type of hedging transaction in sufficient detail to

demonstrate how the clear reflection standard is met. (Treasury Regulation section 1.446-4(d)(1)) For each hedging transaction, in addition to the identification required by Treasury Regulation section 1.1221-2, Treasury Regulation section 1.446-4(d)(2) requires whatever more specific identification is necessary to verify the application of the method of accounting used by the taxpayer for that transaction.

Examination Techniques

Hedging losses should be entered as negative amounts in “other income” on schedule F. However, they are seldom found there. Some losses are deducted as separate items in other expenses and are occasionally found in either cost of sales or in expenses. When the gross profit on a return appears low or expense costs are high in relation to sales, the examiner should consider scrutinizing the accounts for losses from futures transactions since this will not be reflected as separate deductions.

When examining a hedging issue, it is very important to secure the brokers statements and the taxpayer’s worksheets or other records identifying the hedging transactions. At minimum the daily transaction sheets and the monthly summary statements should be secured. The hedger should normally be trading in the same commodity futures contracts as those commodities he is selling or purchasing. The records must show that the commodity hedged is in an amount that is equal to or less than what is being produced, bought, or raised for resale. The contract quantities will be in bushels or pounds. The weight at which the taxpayer normally sells or buys cattle will determine the number of head that his live cattle or feeder cattle contracts will represent. For example, a cattleman who sells fat cattle at 1,100 lbs. will protect more cattle with a contract than the producer that sells at 1,250 lbs.

To examine grain crop hedging it is necessary to secure inventory records, purchase invoices, sales invoices, and the taxpayer’s documents identifying the hedges. When inspecting the broker’s statements, compare the closing dates of the futures to the purchase or sale dates of the related commodity. There should be some relationship between them. Broker’s statements reflecting futures trading in unrelated commodities are an indication that the taxpayer is not reducing risk as required. Usual commodity transactions that do not reduce risk for farmers are: eggs, pork bellies, coffee, silver, gold, copper, and boxed beef. These commodities have no relation to the normal course of business for a farmer, cattlemen, grain dealer, or feedlot operator.

Cancellation of Indebtedness

Background

In 1931 the Supreme Court established the principle that any gain or savings from the reduction or discharge of a debtor’s outstanding indebtedness, for less than the actual

amount due, is income for federal tax purposes. See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). This was later codified under IRC section 61 (a)(12).

However, there are situations where it would create a major hardship if a taxpayer were required to pay taxes on income from a discharge of indebtedness. For example, bankruptcy debts are routinely "settled" or discharged for less than the actual amount due. Under IRC section 61, the forgiven amount would be taxable income. Yet, when a person is already bankrupt or insolvent they are not in a position to pay more taxes. Recognizing this inequity, Congress passed IRC Section 108 that provided exceptions for insolvent or bankrupt taxpayers.

During the 1980's the number of farmers forced into selling the family farm increased dramatically. This caused substantial damage to the affected family and it became apparent that a separate exception for farmers would be beneficial. Thus Congress added IRC section 108(a)(1)(C) in 1986 which provides that gross income does not include any discharge of indebtedness if the indebtedness is from qualified farm indebtedness.

Before any exclusion can be determined, it is necessary to define what is meant by income from the discharge of indebtedness. Generally, a discharge of indebtedness takes place when a creditor reduces, in whole or part, the amount owed. As a general rule, a debtor realizes ordinary income from the discharge of indebtedness equal to the difference between the amount due on the debt and the amount paid for its discharge. The income realized from discharge of debt is includible in gross income, IRC section 61(a)(12). If debt forgiveness is business related, it is reported on the appropriate business form, Schedule F, Profit or Loss from Farming. It is subject to self-employment tax. If the debt is discharged without any payment by the debtor, the entire amount of the indebtedness is the realized gain, *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), X-2 C.B. 356 (1931).

The income amount is easy to calculate when the creditor simply reduces the amount owed. Usually, though the creditor receives some type of non-cash payment which can complicate the identification of discharge income. When a creditor reduces a debt as compensation for services the debt reduction is treated as compensation and not as cancellation of indebtedness. See Treas. Reg. section 1.61-12(a).

In many cases, the debtor transfers property to the creditor under an agreement that either reduces or eliminates the debt. If property is transferred to satisfy a recourse debt (debtor is personally liable) the property is treated as if it were sold by the debtor at Fair Market Value (FMV). Thus, the debtor will realize gain or loss to the extent the FMV exceeds the adjusted basis in the property. Gain or loss from the sale of property is not subject to the exclusion provisions of IRC section 108.

If the recourse debt exceeds the FMV of the property and the creditor releases the debtor from the remaining liability, the difference is income from the discharge of indebtedness (Revenue Ruling 90-16, 1990-1 C.B. 12; Treas. Reg. sections 1.166-6(b) and 1.1001-2(c), Example 8.). In such a case, a taxpayer may realize both cancellation of

indebtedness income and gain or loss from the sale of property. What if the property is transferred to satisfy a non-recourse debt? In that case, the full amount of the canceled debt is treated as proceeds from the sale or exchange of the transferred property and gain is measured by the difference between the basis of the transferred property and the amount of the debt. This is true even if the value of the property is less than the unpaid balance of the debt (*J.F. Tufts*, 461 U.S. 300 (1983)).

Example 1

In 1995 Joe York owed Mary Pope \$100,000. During the year he transferred property with an adjusted basis of \$75,000 and a FMV of \$90,000 in full satisfaction of the debt. If the debt is "recourse debt" Joe will realize a gain of \$15,000 (90,000-75,000) and income from the discharge of indebtedness in the amount of \$10,000. The \$10,000 may be excludable from income if Joe York meets one of the criteria under IRC section 108(e)(2).

If the debt had been "non-recourse debt" Joe would have realized a gain of \$25,000 (100,000 - 75,000) and -0- income from the discharge of indebtedness. None of the gain is subject to exclusion under IRC section 108.

General Rule

The general rule is that taxable income includes discharge of indebtedness income. However, there are several important exceptions in the law to this rule. These exceptions involve:

- The cancellation of a debt intended as a gift;
- The reduction of a purchase-money debt; and
- The cancellation of a deductible debt.

Cancellation of Debt Intended as a Gift (IRC section 102)

Gifts or bequests are excluded from gross income. Congress recognized that the presence of donative intent on the part of the creditor is difficult (if not impossible) to establish in a business setting. The committee reports accompanying the Bankruptcy Tax Act of 1980 state: "*** it is intended that there will not be any gift exception in a commercial context (such as, a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness." Thus, the gift exception generally applies only in noncommercial contexts.

Debt Released by Gift

If debt discharge is intended as a gift, there is no reportable DOI income. The discharged amount is treated as a payment to the creditor and a like amount is deemed given to the debtor as a gift. The IRS considers the donative intent of forgiveness in determining whether debt forgiveness is taxable or treated as a gift. Unless the presumption is refuted,

a familial relationship implies gratuitous gifting. To be considered a gift, the transaction must not be one in which the creditor is simply attempting to dispose of the claim for the “best price available.” A gift tax return may be required if the forgiven amount is more than the annual exemption amount.

Example 2.

A grandson purchases land on contract from his grandfather for \$100,000. The grandson is unable to make his payments so his grandfather reduces the loan to \$80,000. The grandson does not have debt forgiveness income because his grandfather is considered to have gifted the \$20,000 to him. The grandson is considered to have made the \$20,000 payment to his grandfather. Since this gift exceeds the gift tax threshold of \$12,000, the grandfather is required to file a gift tax return. The grandfather must still report a sales price of \$100,000.

Reduction of Purchase Money Debt (IRC section 108(e)(5))

If the seller reduces the amount of purchase-money debt still owed on property, the purchaser of that property will not realize income from the discharge of indebtedness. The reduction of the debt is treated as a purchase-money adjustment for both the seller and the buyer only if:

- The reduction would (but for this exception) result in income from the discharge of indebtedness;
- The reduction does not occur in a bankruptcy case or when the purchaser is insolvent;
- The debt has not been transferred by the seller to a third party;
- The property hasn't been transferred by the buyer to a third party; and
- The reduction in the amount of debt is due to factors involving direct agreements between the buyer and the seller.

Example 3

Ray Moore purchased land from Ben Tate for \$250,000 on contract. Ray paid \$25,000 down and owed Ben \$225,000 of the purchase price. When the outstanding amount of the purchase-money debt was \$220,000, Ben agreed to reduce the debt by \$20,000. Ray was not in bankruptcy or insolvent.

Ray treats the reduction of debt as a purchase-price adjustment rather than as income from the discharge of indebtedness. Thus, Ray must reduce his basis in the property by \$20,000. Ben now reports a sales price of \$230,000 instead of \$250,000.

Discharge of Deductible Debt (IRC section 108(e)(2))

A farmer does not recognize income from the discharge of indebtedness if the payment of such debt would have entitled him to a deductible expense.

Example 4

Roy Cole is a cash basis farmer who owed his local bank \$50,000 principal and \$5,000 of interest. Roy is solvent and is not in bankruptcy. The bank makes Roy an offer to forgive the \$5,000 interest, if he can arrange a loan with another lender and repay the \$50,000 principal in full. Roy refinances with another lender and repays the \$50,000. The \$5,000 of interest is then forgiven. The \$5,000 is not taxable, since the interest would have been deductible if paid. (See also Revenue Ruling 67-200, 1967-1 C.B. 15, for the treatment of interest already deducted by an accrual basis farmer and later discharged by the creditor.)

Exclusions From Income (IRC section 108(a)(1))

Under IRC section 108(a)(1) five situations are provided when debt forgiveness does not result in income to the taxpayer at the time the debt is forgiven RATHER tax attributes are reduced which could lead to FUTURE tax liabilities. These exclusions are applied in the following order:

1. Title 11 bankruptcy;
2. Insolvency;
3. Qualified farm indebtedness;
4. Qualified real property business indebtedness for taxpayers other than C corporations, and
5. Qualified principal residence indebtedness which is discharged before January 1, 2010.

Taxpayers are required to reduce certain tax attributes (for example, net operation loss (NOL), general business credit, minimum tax credit, capital loss, basis in property, passive activity loss, credit carryover, and foreign tax credit) (IRC section 108(b)). In addition, in the case of a taxpayer other than a C-Corporation, the discharged amount of qualified real property business indebtedness may be excluded.

After establishing that a taxpayer has income from the discharge of indebtedness the exclusion applicable, if any, under IRC section 108 needs to be determined.

Title 11 Case

IRC section 108(a)(1)(A) provides that income from the discharge of indebtedness is excluded from gross income, if the debt discharge occurs in a bankruptcy case under Title 11 of the U.S. Code. For the exclusion to apply, the farmer must be under the jurisdiction of the court, and the discharge of debt must be granted by the court or under a plan approved by the court.

Although not required, most grain farmers file bankruptcy under Chapter 12. Chapter 12 is designed for "family farmers" with "regular annual income." It enables financially distressed family farmers to propose and carry out a plan to repay all or part of their debts. Under chapter 12, debtors propose a repayment plan to make installments to

creditors over three to five years (11 U.S.C. section 1222(b) and (c)). Chapter 12 eliminates many of the barriers that farmers might face if seeking to reorganize under either Chapters 11 or 13 of the Bankruptcy Code because it is more streamlined, less complicated, and less expensive than chapter 11, which is better suited to large corporate reorganizations and more advantageous than a Chapter 13, which is designed for wage earners who have smaller debts than those facing family farmers. In chapter 12, Congress sought to combine the features of the Bankruptcy Code which can provide a framework for successful reorganization of a family farm business.

Not all debts are discharged in a Chapter 12 or any other bankruptcy proceeding. Certain categories of debts are not discharged in Chapter 12 proceedings. 11 U.S.C. section 1228(a). Those categories include debts for alimony and child support; money obtained through filing false financial statements; debts for willful and malicious injury to person or property; debts for death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated; and debts from fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny. Also, please be advised that secured obligations may be paid beyond the end of the plan payment period and, accordingly, are not discharged.

Example 5

Amy Barton is under the jurisdiction of the bankruptcy court. Amy has assets with a total fair market value of \$25,000 and a basis of \$23,500. Amy also has liabilities totaling \$33,500. The court grants a discharge of liabilities of \$21,000, requiring Amy to transfer assets with a FMV of \$6,000 and a basis of \$3,500 to creditor James White. Amy realizes discharge of indebtedness income of \$15,000 (\$21,000-\$6,000).

Because the discharge occurs in a Title 11 bankruptcy case, Amy does not recognize any income, but must reduce her tax attributes or benefits by the amount of the excluded income.

Insolvency

IRC section 108(a)(1)(B) provides that income from the discharge of indebtedness is excluded from gross income if the discharge of debt occurs when the farmer is “insolvent” outside of bankruptcy. This exclusion is limited to the amount by which the farmer is insolvent. A farmer is insolvent when he or she has an excess of liabilities over the fair market value of assets, as determined immediately before the debt is discharged (IRC section 108(d)(3)).

For purposes of determining the farmer's insolvency, property exempt from the claims of creditors is not included in determining the FMV of the farmer's assets. Since exempt assets are not subject to the claims of creditors, no economic gain is realized from a “freeing of assets” due to the discharge of indebtedness. Those assets which are considered exempt from the claims of creditors are determined under state law.

Example 6

Janice Zapata has liabilities of \$40,000 and assets with a FMV of \$34,000. Her creditors agree to discharge \$10,000 of her liabilities, if she repays the remaining \$30,000. Under state law, \$3,000 of Janice's assets is exempt from the claims of creditors. Her insolvency is computed as follows:

Janice's Insolvency	
FMV of assets	\$34,000
Less: Exempt assets	\$3,000
Balance of nonexempt assets	\$31,000
Less: Liabilities	\$40,000
Amount of Insolvency	\$9,000

Janice can exclude \$9,000 of debt-discharge income, the amount not in excess of her insolvency. The balance of the discharged debt, \$1,000 (\$10,000-\$9,000), must be included in gross income.

The insolvency exclusion under IRC section 108 applies only to income from the discharge of indebtedness. For all other types of income (for example, wages, rents, income, and gains from dealings in property), the solvency of the farmer is irrelevant (*Estate of Delman v. Commissioner*, 73 T.C. 15, 32 (1979)). Thus, an insolvent farmer, who transfers property to a creditor in discharge of indebtedness will not qualify for the insolvency exclusion on that portion of the gain attributable to the deemed disposition of property.

Priority of Exclusions

A farmer, who has a debt discharged in a bankruptcy proceeding, treats the discharge as an exclusion from income under the Title 11 exclusion. This exclusion takes precedence over any other exclusion. The insolvency or farm indebtedness exclusions cannot be applied to a discharge which occurs in a Title 11 case (IRC section 108(a)(2)(A)).

For debts discharged outside of bankruptcy, the insolvency exclusion takes precedence over the farm indebtedness exclusion. In other words, a farmer whose debts are discharged outside of bankruptcy must first apply the insolvency exclusion to the debt discharged amount before the farm indebtedness exclusion or the qualified real property business indebtedness exclusion can apply.

Since both the insolvency provision and the bankruptcy provision take priority over discharge from qualified farm indebtedness, only a solvent farmer who is not in bankruptcy can have qualified farm indebtedness. However, an insolvent farmer who has

income from the discharge of indebtedness excluded under the insolvency exception and, thereby, becomes solvent, can then use the farm indebtedness exclusion.

Reduction of Tax Attributes

IRC section 108(b) requires a farmer to reduce certain specified tax attributes or benefits, if the farmer is eligible to exclude from current taxable gross income certain income realized from the discharge of indebtedness. The amount excluded from current income is in effect deferred and used to reduce future, potential tax savings.

Definition of Farming

Most of us feel confident that we can recognize a farm when we see one. However, it is not always that simple, especially with the large integrated companies. Some companies are vertically integrated from the breeder stock to the grocery store. This leaves us with the question: "Where does the farming operation stop?" IRC section 108(g) does not define the term "trade or business of farming" for purposes of this exclusion.

Over the years several court cases as well as numerous Code sections emerged during the struggle to properly define the farming business. In *Maple Leaf Farms v. Commissioner*, 64 T.C. 438 (1975), acq. 1975-2 C.B. 2, the court held that "farming" includes the operation of an integrated poultry-processing business. Maple Leaf Farms was extremely small by today's standards and did not include the tremendous extension into further processing activities engaged in by most of the current integrated companies. In many ways this has confused the issue by making it appear that today's integrated companies will qualify as farming businesses from start to finish. This is not accurate.

The Code contains numerous definitions of farming, none of which include the processing activity. IRC section 464(e) defines farming as:

***[T]he cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this definition, trees (other than trees bearing fruit or nuts) are not treated as an agricultural or horticultural commodity."

Treas. Reg. section 1.61-4(d) provides that the term "farm" embraces the farm in the ordinarily accepted sense. It does not include processing operations. IRC section 108(a)(1)(C) was included in the Code under the same Act in 1986 that brought in IRC section 263A. In recognition of the need for a more specific farming definition Temp. Treas. Reg. sections 1.263A-4(a)(1), 1.263A-4(a)(4)(I) and 1.263A-4(a)(4)(ii) state that the term "farming business" does not include the processing of commodities or products beyond those activities which are normally incident to the growing, raising, or harvesting of such products. This is confirmed under Treas. Reg. section 1.263A-4(a)(4)(iii) Example 3, that specifically reviews an integrated poultry operation and concludes the business of farming stops where the meat processing operation begins.

Some of the integrated companies maintain separate subsidiaries for the farming and processing operations which make it much simpler to distinguish the manufacturing activities from the farming activities. Even with separate entities, the examiner should still review the SEC filings, annual reports, and proxy statements for information which divides the total sales between farming activities and processing or manufacturing activities.

Qualified Farm Indebtedness

IRC section 108(g)(2) provides the two basic rules governing the definition of qualified farm indebtedness:

- The indebtedness must be "incurred directly in connection with the operation by the taxpayer of the trade or business of farming.
- 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years proceeding the taxable year in which the discharge of indebtedness occurs is attributable to the trade or business of farming.

In specifying the type of debt contemplated in this section, the Senate Finance Committee stated that:

Qualified agricultural indebtedness is defined as debt incurred to finance the production of agricultural products * * * (including timber) or livestock in the United States, or farm business debt secured by farmland or farm machinery and equipment used in agricultural production. S. Rep. No. 99-313, 2d Sess. 272 (1986).

Qualified Person

Congress wished to ensure that only people who truly needed the special help received benefit from the discharge rules. Thus there are several limitations under IRC section 108(g)(1)(B). In order to be a qualified person:

- The creditor must be actively and regularly engaged in the money lending business or a government agency or its agent;
- The creditor cannot be related to the farmer;
- The creditor cannot be the person (or a person related to such person) from whom the farmer purchased or received the property; and
- The creditor (or a person related to the creditor) cannot receive a fee with respect to the farmer's investment in the property. (Note: This limitation eliminates the possibility of profit for a shelter promoter.)

Limitations

The exclusion for the discharge of farm indebtedness is limited by IRC section 108 (g)(3) to the total of the taxpayer's adjusted tax attributes in the year the debt is cancelled plus the total adjusted basis in all qualified property held by the taxpayer as of the beginning

of the tax year after the tax year in which the discharge took place. Anything over the limitation amount is recognized as taxable income.

The limitation accomplishes two purposes. It defers the recognition of income by spreading it over the depreciable lives of the farmer's remaining assets. If the tax attributes are not large enough to provide a deferral it causes the income to be currently reported thus ensuring that the income will not be permanently deferred. Congressional intent was to allow a deferred benefit rather than a complete exclusion for solvent farmers which would, in turn, ease the credit crisis in the farming sector.

Example 7

The Farmers Home Administration (FmHA) discharged \$12,000 of farm debt incurred by Ada Bullock. For the three years immediately preceding the debt discharge year, 50 percent or more of Ada's total gross receipts were attributable to farming.

The full \$12,000 is excludable from Ada's income under IRC section 108 (a)(1)(C) subject to the limitations in IRC section 108. The discharge was made by a qualified person and the debt was qualified farm indebtedness.

Reduction of Tax Attributes for Farmers

Earlier it was noted that the bankruptcy and insolvency exclusions take precedence over the exclusion for farmers. This is important. In addition to limitations on farm debt, the order of reduction in tax attributes differs based on the specific exclusion under which the discharge qualifies. Under IRC section 108(g) the exclusion for qualified farm indebtedness cannot exceed the sum of:

1. the adjusted tax attributes of the taxpayer; and
2. the aggregate adjusted basis of all qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year of discharge.

The order in which these tax attributes must be reduced under the farm exclusion is:

1. Net operating losses;
2. General business credit carryovers;
3. Minimum tax credit;
4. Capital loss and capital loss carry forward;
5. Basis of qualified property;
6. Losses and credits disallowed (and suspended) per passive loss rules; and
7. Foreign tax credit carryovers.

The main difference under this exclusion versus the bankruptcy and insolvency exclusion involves the reduction to asset basis. The farm exclusion limits the basis reduction to qualified property but does not change the order in which the attributes are reduced. See

IRC section 1017(b)(4). Qualifying property for farmers is property used or held for use in a trade or business or for the production of income.

Example 8

John Dade received \$20,000 income from the discharge of qualified farm indebtedness. He has the following assets and basis:

- Personal Residence - 50,000
- Rental Property - 10,000
- Tractor - 0

If John is insolvent or under a Title 11 bankruptcy, he can apply the basis reduction to all assets. Under the farm exclusion, only the tractor and the rental property are qualifying property.

Note: The exclusion is not limited to farm property. Rental property qualifies as income producing property.

Any reductions to basis are treated as depreciation reductions subject to recapture if the property is later sold or disposed of by the taxpayer. See IRC section 1017 (d).

Amount and Manner of Reduction of Tax Attributes

Generally, the amount of the reduction in tax attributes is one dollar for each dollar of income excluded, except for credits where the reduction is 33 1/3 cents for each dollar excluded. The reduction to the tax attributes is made after the end of the tax year. Thus, it does not affect the year of discharge.

The reductions within each category of attributes pertaining to losses and credits are made in the order in which the attribute would have been used. Thus, the current year's loss would be reduced first then any further reductions would be made to loss carryovers in the order in which they arose. This holds true for the credits and credit carryovers also. An excess of discharge over the available tax attributes and qualifying property is gross income except for taxpayers relying on the qualified farm indebtedness exclusion of IRC section 108(a)(1)(C). Taxpayers in bankruptcy can exclude amounts in excess of their reduction in tax attributes. Insolvent taxpayers can exclude amounts in excess of their reduction in tax attributes, but only up to the amount of the insolvency.

Under IRC section 1017(b)(4)(C), an interest of a partner in a partnership, or a stock interest of a parent corporation in an 80 percent or more owned subsidiary, may be treated as depreciable property for basis reduction purposes if there is a corresponding reduction in the basis of qualifying depreciable property held by the partnership or corporation.

Reduction of Basis: Bankrupt or Insolvent Debtors

Under IRC section 1017(a), the basis reduction required by IRC section 108(b)(2) or IRC section 108(c)(1) applies to the basis of any property the farmer held at the beginning of the taxable year following the taxable year in which the discharge occurred.

If the canceled debt income is excluded due to bankruptcy or insolvency, the reduction in basis of property is limited. IRC section 1017(b)(2) provides that the reduction in basis, under IRC section 108(b)(2), cannot be more than the amount by which the total basis of property the farmer holds exceeds the farmer's total liabilities, computed immediately after the discharge. This limitation to the reduction in the basis of assets does not apply if the farmer bypasses the required order of tax attribute reductions specified in IRC section 108(b)(2) and elects to first reduce the basis of depreciable assets owned.

Until further regulations are issued, in the case of a cancellation or reduction of indebtedness in any bankruptcy proceeding, the reduction in the basis of assets is made in the following order (Treas. Reg. sections 1.1016-7 and 1.1016-8):

1. Against the property for which the debt was incurred, except inventories and receivables;
2. Against property subject to a lien (other than a lien securing indebtedness incurred to purchase such property), except inventories and receivables;
3. Against any other property, except inventories and receivables; and
4. Against inventories and receivables.

Reduction of Basis: Discharge of Qualified Farm Debt

If the basis reduction required by IRC section 108(b)(2) is due to the exclusion of income realized from the discharge of qualified farm debt, IRC section 1017(b)(4) provides that the excluded income shall be applied only to reduce the basis of qualified property (any property used or held for use in a trade or business or for the production of income). The reduction must occur at the beginning of the taxable year following the taxable year in which the discharge occurs. The reduction to the basis of qualified property is applied in the following order:

1. Depreciable property;
2. Land used or held for use in the business of farming; and
3. Any remaining qualified property not described in (1) or (2) above.

Election to Reduce Basis of Depreciable Property

As an alternative to the ordering rules for attribute reduction specified in IRC section 108(b)(2), a farmer may elect (by filing Form 982 with the tax return in the year discharge occurs) to first apply any portion of the excluded income to reduce basis of depreciable property. This election is available under IRC section 108(b)(5) for farmers with debt-discharged income excluded due to bankruptcy, insolvency, or to the discharge of qualified farm indebtedness. Any excluded debt-discharged income which is not

absorbed by the basis of depreciable property, is then used to reduce other tax attributes in the prescribed order.

Definition of Depreciable Property

Under IRC section 1017(b)(3)(B), depreciable property is any property subject to an allowance for depreciation, but only if the basis reduction reduces the amount of depreciation or amortization which would otherwise be allowable for the period immediately following the reduction. In certain instances, depreciable property may include a partnership interest, stock held by a parent in a subsidiary, or real property held as inventory (IRC section 1017).

The reduction in basis takes place at the beginning of the taxable year following the taxable year in which the discharge occurs. It cannot exceed the total adjusted basis of depreciable property the farmer holds at that time.

Under IRC section 108(b)(5), the reduction of the basis of depreciable property the farmer holds follows the same order specified in Treas. Reg. sections 1.1016-7 and 1.1016-8 for the reduction of basis of assets under IRC section 108(b)(2).

Recapture of Basis Reductions

If the basis of property is reduced under IRC section 108(b)(2) or IRC section 108(b)(5), any non-IRC section 1245 or non-IRC section 1250 property is treated as IRC section 1245 property. Any reduction is treated as a depreciation deduction subject to recapture. This recapture rule applies to any reduced-basis property, whether depreciable or non-depreciable, and whether or not a disposition of such asset would otherwise be subject to recapture under IRC section 1245 or section 1250. In the case of IRC section 1250 property, the computation of the amount of straight-line depreciation under IRC section 1250(b) is made as if there had been no reduction of basis under IRC section 1017.

Example 9

In 1987, Fred Pratt, a solvent farm debtor, had \$600,000 of qualified farm indebtedness discharged by the bank. As a result, Fred excluded discharge of indebtedness income by reducing attributes, including \$250,000 of basis in land. In 1990, Fred sold the land to Jay Baxter on contract. Terms were 20 percent down, with balance payable over 15 years at 10 percent interest.

Since the land is non-IRC section 1245 or non-IRC section 1250 property, it is treated as IRC section 1245 property. The installment sale provisions under IRC section 453(i) would trigger recapture income of \$250,000 in 1990.

Partnerships and S-Corporations

IRC section 108(d)(6) provides that the gross income exclusion (of income realized from discharge of indebtedness due to bankruptcy, insolvency, or discharge of qualified farm indebtedness), as well as the related tax attribute reductions be applied at the partner's level, not the partnership's level. Thus, an insolvent or bankrupt partnership must recognize income from the discharge of a partnership debt, and treat it as an income item allocable to its partners under IRC section 702(a). While the partner's basis in the partnership is increased by the allocated amount of debt-discharge, a corresponding reduction in the partner's share of partnership liabilities results in a decrease in basis.

If the partners are bankrupt or insolvent, they may rely on the bankruptcy or insolvency exceptions to exclude the allocated debt-discharge amount from their gross income.

Example 10

ABC Partnership is the debtor in a bankruptcy case in which a partnership liability of \$30,000 is discharged. The partnership has three partners (Abe Allen, Bill Benton, and Chad Camden) with equal distributive shares of partnership income and loss items. Partner Abe is the debtor in a bankruptcy case; partner Bill is insolvent (by more than \$10,000), but is not a debtor in a bankruptcy case; and partner Chad is solvent and is not a debtor in a bankruptcy case.

In the case of bankrupt partner Abe, his share (\$10,000) of the debt discharged amount must be applied to reduce his tax attributes, unless he elects first to reduce the basis of depreciable assets owned. The same tax treatment applies in the case of insolvent partner Bill. Solvent partner Chad must recognize \$10,000 of income from the discharge of indebtedness.

Unlike partnerships, the exceptions for exclusion of debt-discharged income in the case of S-Corporations are applied at the corporate level. This rule insures that the shareholders of all corporations are treated in the same manner. Any debt discharged income excluded (due to bankruptcy, insolvency, or discharge of qualified farm debt) reduces the corporation's tax attributes.

Shareholder-Corporation Transactions

A corporation realizes income from the discharge of indebtedness under IRC section 108(e)(6) to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt. Thus, the discharges of indebtedness rules apply when a cash-basis farmer contributes a debt (representing an accrued and deductible expense) to the capital of an accrual-basis corporation.

In general, this provision will not affect transactions between farmers and their family farm corporations, since each entity usually employs the cash method of accounting. In those instances where a family farm corporation is required by IRC section 447 to use the accrual method, the matching provisions under IRC section 267 further serve to eliminate inconsistent reporting of transactions between farmers and their family corporations.

Forgiveness of Shareholder Debt

The discharge of indebtedness of a shareholder by a corporation is treated as a distribution of property. A solvent shareholder whose debt to a corporation is forgiven realizes dividend income to the extent of the corporation's earnings and profits available for distribution.

If the shareholder's debt is canceled in connection with the complete liquidation of the corporation, the cancellation is treated as a distribution in exchange for the shareholder's stock. Consequently, the debt cancellation enters into the determination of the shareholder's gain or loss on the liquidation.

Acquisition of Debt By Related Party

If a debtor's outstanding debt is acquired from an unrelated creditor by a party related to the debtor, IRC section 108(e)(4) treats the acquisition as if it were made by the debtor. As a result, the debtor realizes income from the discharge of indebtedness, measured by the adjusted basis of the related person in the debt on the acquisition date. (Treas. Reg. section 1.108-2(f)(1)). This provision may apply to those acquisitions effected within 6 months of a party becoming related (Treas. Reg. section 1.108-2(c)(3)).

If the debtor subsequently pays the debt that was acquired by the related party, the entire transaction is to be treated as if the debtor had originally acquired the debt. If the acquisition of a debt results in debt-discharged income under related-party rules, the transfer of the debt as a contribution to capital by the related party to the issuing corporation will not result in income a second time.

Examination Techniques

Income from the discharge of indebtedness can arise in a wide array of circumstances. Identifying those situations that result in a discharge of indebtedness is the key to this area of tax law. This is not always easy, since a farmer may not recognize that a taxable event has occurred or may incorrectly apply the exclusion provisions of IRC section 108.

Examiners, in addition to reviewing the farmer's books and records, should review the tax return and any attachments (such as Form 982) for indications of discharge of indebtedness. The initial interview also provides the examiner with an excellent opportunity to ask questions about the farmer's financial position and the existence of any canceled debts. Audits have produced sizeable adjustments in the following areas.

- Solvent partners incorrectly exclude debt-discharged income due to the insolvency of the partnership. Insolvent partners have also attempted to exclude their distributive share of partnership income as debt-discharged income. Examiners should review any decrease in partnership liabilities and ensure that debt-discharged income, as well as other items of partnership income, are correctly reported on the partner's return.

- When debtors perform services in payment of debt, no income is realized from the discharge of indebtedness. The debtor is considered to have received taxable compensation equal to the amount of debt canceled. Hence, no income can be excluded under IRC section 108(a), irrespective of the status of the farmer (Treas. Reg. section 1.61-12(a)).
- Farmers incorrectly reduce attributes by the earliest year of any attribute instead of reducing attributes in the prescribed order (NOL'S, credits, capital loss, etc.).
- The election to first apply any portion of the excluded income to reduce basis of depreciable property must be made on Form 982 in the taxable year of discharge. After notification of an examination, the farmer cannot invoke the provisions of IRC section 108(b)(5).
- Farmers incorrectly consider land as depreciable property when making an election under IRC section 108(b)(5).
- Corporations whose debt was acquired at a discount from a bank or government agency by a controlling shareholder (related party) improperly omit the discharge of indebtedness income on Form 1120.
- Farmers improperly assert that when loans are forgiven, by a lender not regularly engaged in the business of lending money, they can avail themselves of the provisions of IRC section 108(a)(1)(c). See “Acquisition of Debt by Related Third Party” above.
- Property which is neither IRC section 1245 property nor IRC section 1250 property must be treated as IRC section 1245 property when basis was reduced due to discharge of indebtedness. Farmers fail to apply the recapture provisions to certain sales of farmland in accordance with IRC section 1017(d). Also, the installment sale provisions under IRC section 453(i) provide for recognition of recapture income in the year of disposition.
- Disputes may arise in determining the extent of a farmer's insolvency. The following sources may prove useful in establishing the property's valuation:
 - Obtain a county map from an abstracter, then reference the properties in question along with sales of comparable properties;
 - Review any appraisals used by the farmer and lending institution in discharging the obligation;
 - Consider obtaining an independent appraisal;
 - Contact local abstracters or realtors who specialize in sales of farmland to obtain listings of comparable sales and other market information pertinent to your geographical area;
 - Some states impose an excise tax on the transfer of property. This may be used to closely approximate the selling price of property (For example, Oklahoma requires “document stamps” on property transfers, but this is not always a reliable indicator of value, as there is no prohibition from purchasing extra stamps.);
 - In Kansas, a “sales price validation questionnaire” is filed by the seller or the seller's agent with the Register of Deeds Office in the county in which the property is located (The agent may obtain a copy of this form by issuing a summons. This potential source of information should be considered on a state-by-state basis.);

- Also, the Kansas Society of Farm Managers and Appraisers publishes a list of farmland sales by county, but many sales are omitted from this publication. Experienced appraisers will not rely solely on the sales contained in this publication (Check and see if your state has a similar publication.).
- Estimate equipment values by contacting area implement dealers and farm auctioneers;
- In evaluating whether to extend credit for the acquisition of farmland, a lender has two primary considerations: The company's cash-flow and the equity in collateral.

Cash-Flow

Due to the size and ever changing nature of some entities, the lender may experience difficulty in analyzing the company's cash-flow. Change is manifested in several ways: 1) management is constantly acquiring or selling property; 2) management opts to transfer land among related entities in order to maximize agricultural program payments; 3) management may choose to use some entities as operating companies (tenants) and other entities (landlords) to hold title to farmland. Therefore, the lender tends to rely on cash-flow projections for the farmer's entire operation.

Equity in Collateral

As a general rule, agricultural lenders try to limit farmland loans to between 60 percent and 70 percent of appraised value. The Farm Credit System limits its loans to 65 percent of appraised value. Factors that may affect the value of a parcel of land include: 1) quality and depth of water; 2) accessibility of the property; 3) topography; 4) the amount of wasteland. A farmer often argues that a blockage factor should apply to large parcels of land. However, the IRS has generally disregarded such arguments.

Review the lender's appraisal and loan approval workpapers. These documents may address the blockage factor by indicating whether the property could be divided into tracts of any size for the purpose of marketing, and whether the tracts could be operated independently. The appraiser or lender will consider the adequacy of roads, irrigation wells, etc.

Real estate mortgages are of public record and may be inspected at the Register of Deeds Office or the County Recorders Office. The recorded mortgage may provide some evidence of value by using the 60 percent to 70 percent rule-of-thumb to estimate the property's value at the time a mortgage is recorded. Consider the following:

- Mortgages on comparable farmland;
- Mortgages initiated by refinancing from a new lender in a later year;

Note: The above-stated list is not inclusive, but provides ideas of the kinds of adjustments to look for.

Information Document Request (Form 4564)

- Form 1099-A.
- Detail depreciation schedules.
- Prior years tax returns:
 - Substantiate that 50% of gross receipts for prior three years is attributable to farming.
 - Corroborate schedules detailing the taxpayer's net operating loss carryover, capital loss carryovers, and tax credit carryovers.
- Basis in land:
 - Purchase contracts
 - Property tax statements, including legal descriptions, necessary to substantiate that taxpayer held land as of the first day of taxable following the year of discharge.
- Bankruptcy records should include:
 - Petition for bankruptcy and accompanying schedules of assets, liabilities, and pending lawsuits (including case numbers if available). "Fair market value" information usually consists of taxpayer's personal estimates. However, a creditor may file an objection if the values appear unrealistic;
 - Docket (i.e. case history which lists a short description of each plead) referencing all entries in the bankruptcy records; and
 - Documents indicating when the plan was dismissed or settled.

Note: This information can usually be secured through the Clerk of the Federal Bankruptcy Court. In the event such records were previously transferred to the Federal Records Center, the bankruptcy court will provide the document numbers in order to locate the items at the Federal Records Center. These files will provide you with a detailed list of assets, liabilities, disposition of assets, debts forgiven, and other information which may be helpful in your case.

- Insolvency computations should include:
 - FMV of assets;
 - Verify that excluded assets are truly excludable; and
 - Supporting documentation used to estimate FMV including appraisals, comparable sales, etc.
- Creditor information should include:
 - Master notes and security agreements.
 - Documents specifying the debts cancelled.

Foreclosures, Repossessions, and Abandonment

Debt Discharged By Transfer of Property

Farmers who cannot make the payments on their loans may be forced to give up their properties in order to discharge their debt obligations. In many cases, the property transferred has been worth much less than the amount of the debt discharged by the transfer. A farmer who transfers property in satisfaction of a debt may realize a gain or loss, and in some cases, income from discharge of indebtedness.

Transfer Treated as a Sale or Exchange

A farmer who transfers property, voluntarily or by foreclosure, in full or partial satisfaction of a debt, is treated as having sold or exchanged the property. If the debt satisfied as a result of the property transfer is a recourse debt, the debtor-transferor may also realize income from the discharge of indebtedness (Treas. Reg. section 1.1001-2(a)(2)).

In most instances, a farmer's obligations will be recourse through the printed form of a note and a recorded mortgage for real estate. However, a farmer who wants to purchase land may be unable to secure financing from a conventional lender; thus, seller financing must be obtained to complete the deal. This type of financing usually takes the form of a land contract, commonly referred to as a contract for deed, real estate contract, or installment sales contract. In the event of default, the seller's remedy is often restricted to repossession of the property. Absent the buyer's personal liability, these financing arrangements are considered nonrecourse.

Discharge of Recourse Debt

If the debt satisfied by the transfer of the property is recourse (personal liability), Treas. Reg. section 1.1001-2(a) treats the property as if it were sold by the debtor at fair market value (FMV). Thus, the debtor-transferor realizes a gain or loss from the sale of the property to the extent the deemed sales proceeds (FMV) exceed the adjusted basis of the property. If the debt exceeds the FMV of the property and the creditor releases the debtor from the remaining liability, the difference is taxable as income from the discharge of indebtedness (Rev. Rul. 90-16; Treas. Reg. sections 1.166-6(a); 1.1001-2(c), Example (8)).

Discharge of Non-recourse Debt

If the debt satisfied by the transfer of the property is non-recourse (no personal liability), the full amount of the canceled debt is treated as proceeds from the sale or exchange of the property, even if the value of the property is less than the unpaid balance of the debt (*J.F. Tufts, S. Ct., 83-1 U.S.T.C. 9328*).

Consequently, any gain or loss from the transfer of property in satisfaction of a non-recourse debt is treated as arising entirely from a disposition of the property, and none of the cancelled debt is considered income from discharge of indebtedness under IRC section 61(a)(12). The distinction between any gain resulting from the sale of property and income from the discharge of indebtedness is critical, because income from the

discharge of indebtedness may be excluded from gross income (IRC section 108; Treas. Reg. section 1.1001-2(c), Example (7)).

Discharge of Debt Secured by Property

The discharge of a recourse or non-recourse debt without a corresponding transfer of property results in income from discharge of indebtedness (Rev. Rul. 82-202), whether or not the debt exceeds the value of the property (Rev. Rul. 91-31).

Example 1

John Tate borrowed \$1,000,000 from ABC Bank to purchase a parcel of land from Joyce Jenkins. The debt was evidenced by a note which was secured by the land. John had no personal liability with respect to the note (nonrecourse debt). When the value of the land was \$800,000 and the outstanding principal on the note was \$1,000,000, ABC Bank agreed to modify the terms of the note by reducing the note's principal to \$800,000. John realized income from the discharge of indebtedness of \$200,000 as a result of the modification of the debt.

If John had originally acquired the property on contract (for example, seller financed), the above would constitute a “purchase-money adjustment” within the scope of IRC section 108(e)(5). See the “Cancellation of Indebtedness” chapter.

In Rev. Rul. 92-53, the IRS stated that the amount by which a non-recourse debt exceeds the FMV of the property securing the debt is taken into account in determining whether a farmer is insolvent (IRC section 108(d)(3)), but only to the extent that the excess non-recourse debt is discharged.

Character of Gain or Loss

A gain or loss recognized on the transfer of property through foreclosure or repossession is taxed the same way as a gain or loss from sales or exchanges (IRC section 1001(c); IRC section 61(a)(3)). A gain from property held for personal use is taxed as capital gain. Property used in a trade or business and held for more than 1 year is IRC section 1231 property. Gain or loss from the sale or exchange of IRC section 1231 property, whether by foreclosure or repossession, may qualify as long-term capital gain or loss.

Example 2

In 1988, Art Benton entered into a contract to buy land from Bart Douglas for \$300,000. The terms were 10 percent down with the balance payable over 15 years. Interest is to be computed on the declining principal balance at 10 percent. Art claimed total water depletion of \$25,000 for 1989 and 1990. In 1991, he assigned the property with a FMV of \$220,000 to Charles Decatur who assumed the unpaid balance of \$260,000. Art was insolvent in 1991.

Art would have a basis of \$275,000 (\$300,000 - \$25,000) in the land. If the debt was recourse, Art would have a \$55,000 (\$220,000 - \$275,000) IRC section 1231 loss and \$40,000 (\$260,000 - \$220,000) discharge of indebtedness income. Some of the discharge of indebtedness income would be excludible to the extent of his insolvency. If the debt was non-recourse, he would have a \$15,000 (\$260,000 - \$275,000) IRC section 1231 loss.

Abandonment of Property

If property securing payment of a debt is the sole means of paying that debt, the abandonment of that property results in the debtor realizing income from the release of the debt. Likewise, a debtor who abandons property secured by a recourse debt, will realize income from discharge of indebtedness if the lender cancels the debt. The property has been abandoned when the farmer irrevocably discards it, cannot use it again or retrieve it for sale or exchange.

Information Reporting

Under IRC section 6050J, a farmer may receive Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property, if a lender:

- Acquires an interest in any property which is security for the farmer's indebtedness in full or partial satisfaction of the debt; and
- Has reason to know that the property has been abandoned.

A lender is treated as acquiring an interest in property that secures a debt if:

- The lender purchases the property at a sale held to satisfy the debtor's loan (for example, a foreclosure sale); or
- The property is sold to a third party, and the sales proceeds are applied to satisfy any portion of the lender's loan.

The reporting requirements under IRC section 6050J apply to real property (for example, a personal residence), intangible property, or tangible personal property held for investment or used in a trade or business.

Under IRC section 6050P, a lender must file Form 1099-C, Cancellation of Debt, for any cancelled debt of \$600 or more if the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. Lenders that are required to file Form 1099-C, may include the information about foreclosure, repossession, or abandonment on that form instead of Form 1099-A.

Examination Techniques

- A gain on a property transferred due to repossession or abandonment is sometimes incorrectly characterized as income from discharge of indebtedness. The farmer may do this in an attempt to exclude the gain under IRC section 108. For example:
 - A number of farmers incorrectly compute gain from the foreclosure of property subject to nonrecourse debt. The farmer will often use the fair market value of the property instead of the amount of the discharged debt as the measure of gain.
 - Farmers treat gain from the foreclosure of property secured by nonrecourse debt as debt-discharged income and exclude the gain because of insolvency. Examiners should carefully review the character of any excluded income to ensure that it is debt-discharged income, as opposed to some other type of income.
- The examiner should review information returns (Form 1099-A or C) issued to the farmer to ascertain that the farmer has correctly reported all transactions relating to the issuance of the Forms 1099-A or C. Many times Forms 1099-A issued by the FmHA are incorrect and are virtually impossible to get corrected.

Farm Business Expenses

General Farm Expenses

General farm expenses include feed, seed, fertilizer, chemicals, fuel, insurance, taxes, interest, rent, storage & warehousing, repairs & maintenance and meals & lodging. The agent should utilize the specific lead sheets associated with these expenses. These expenses are discussed below.

Feed

Feed expense for livestock is generally deductible when paid. Most of the rules that apply to the deductibility of prepaid feed are contained in Rev. Rul. 79-229. The gross profit on sales of livestock can be compared to the feed cost to determine if this cost is excessive. The cost of raised feed is deducted as the costs of production are incurred. No additional deduction is allowed when the grain is fed, unless the amount is also included in income.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Seed

The cost of seeds and plants used to produce crops for sale is deductible when paid. However, there are two exceptions to this rule:

- The planting may constitute a capital expenditure if it has a value lasting over several taxable years (for example, orchards and timber farms); and

- If the crop method of accounting was elected, the cost of the seeds or plants will not be deductible until the year when income from the crop is realized.

A large seed expense could be indicative of seed purchases for sales to other farmers or prepaid seed. Look for any income from seed sales in this situation or prepaid seed contracts.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Fertilizer

The full cost of fertilizer, lime, or other soil conditioners is deductible as a current expense, if the effectiveness of the material applied will not last longer than 1 year. If the effectiveness lasts longer than 1 year, the expense of acquisition is a capital expenditure; however, under IRC section 180 a farmer can elect to currently deduct such expenditures that should otherwise be capitalized. Thus, all fertilizer costs will usually be deducted as current expenses. Most grain farmers will have substantial fertilizer expenses. In addition, check for prepaid fertilizer issues.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Chemicals

Chemicals used on a farm to control weeds (herbicides) or insects (insecticides) are deductible. Herbicides play an important part in no-till cultivation. Therefore, these costs may be significant.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Fuel

The cost of diesel, gasoline and other fuels and oil used in farming operations is deductible. If the farmer irrigates, irrigation fuel can be a significant expense. Look closely at fuel purchases to verify that no fuel is diverted for personal use.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Insurance

Crop insurance is used to cover crop losses from natural disasters. This can be a major expense for grain farmers. Premiums paid for casualty insurance on all farm property, liability insurance, and health/accident insurance covering employees are deductible expenses. Many farm policies are blanket policies that include the personal residence, personal vehicles and personal property. Verify that the personal portion of the policy has been separated out from the portion deducted. Premiums paid for a disability policy, providing payments to the farmer in case of an accident or sickness, are personal

expenses and are not deductible. Health insurance should be deducted as an adjustment to income on page 1, Form 1040. If no deduction was taken on page 1, Form 1040, then it is possible that the entire amount was deducted on Schedule F (unless the spouse has health insurance through an outside employer).

By hiring a spouse as an employee, a farmer can take advantage of IRC section 105, which allows small businesses to deduct 100 percent of costs of employee benefits. A farmer transfers the family insurance plan to the spouse's name, listing the farmer as a dependent. All family health insurance premiums and uninsured medical costs are then deductible as business expenses. The 100 percent deductions can be taken only after the farmer and spouse have formalized their employer-employee relationship. They need a written employment agreement outlining the spouse's duties. The agreement also must specify reasonable wages and benefits. The IRS does not permit employee discrimination; the same benefits must be made available to all employees taking into consideration age and length of service requirements. If the spouse is co-owner of the land, equipment and debt, it is probable that she/he is a co-proprietor rather than an employee. There has been significant legislation on this issue in the last couple years. If you have this issue, make sure you research current legislation.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Taxes

A farmer can deduct as a business expense the following taxes:

- Real estate and personal property taxes on farm business assets;
- Social security and Medicare taxes paid to match the amount withheld from the wages of farm employees;
- Federal unemployment taxes on farm employees;
- One-half of self-employment tax (adjustment to income on page 1, Form 1040); and
- Federal use taxes paid on highway motor vehicles used for farming.

Taxes paid on the portion of farm assets used for personal purposes and Federal or state income taxes are not deductible as farm expenses, although such taxes can be deducted on Schedule A, Form 1040, if the farmer itemizes deductions.

State or local sales taxes imposed on the purchase of capital assets for use in farming operations should be added to the basis of the asset acquired, not separately deducted.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Interest

Interest paid on farm mortgages and other obligations incurred to carry on farming operations are deductible as a business expense. If the farmer uses the cash method, the

interest is deductible in the year of payment. Accrual method farmers may deduct interest as it accrues. Most farmers' business and personal assets and loans are so intertwined, it is possible that personal interest could be deducted on Schedule F (for example, a loan on a personal car could be obtained through an addition to an operating loan). If the proceeds of a loan are used for both business and personal purposes, ensure the interest is properly allocated. Since personal interest is no longer deductible on Schedule A, this could be a significant issue.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Rent

Rent paid in cash may be deducted on Schedule F in the year paid; however, rent paid in crop shares is nondeductible, since the cost of raising the crops was deducted as a farming expense. Advance payments of rent may only be deducted in the year to which they apply, regardless of the farmer's method of accounting. Be alert for year-end rent payments. A tendency is to prepay rent like other expenses, but prepaid rent is not deductible. The first half of rent is usually due on March 1. Many times farmers will pay rent to a spouse or related corporation to reduce the self-employment tax liability. If this occurs, verify that there is a true lessor-lessee relationship.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Storage and Warehousing

The cost of grain storage or other warehousing is deductible. These costs are generally deducted from sales proceeds when the stored grain is sold. A double deduction can occur if the farmer reports only the net amount of the sale and then claims a deduction for storage and warehousing costs.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Repairs and Maintenance

The cost of repairing and maintaining equipment is deductible. The cost of replacing equipment is a capital expenditure subject to depreciation. Likewise, the cost of an extensive overhaul is a capital expenditure if the overhaul adds value, prolongs the life of the equipment, or adapts it to a new or different use.

Just because the amount of an expenditure is large does not necessarily mean it's a capital expenditure. Sometimes there is a fine line between repair and improvement. For example, the purchase of a used transmission for a farmer's loader (cost \$17,500) was a repair because it returned the equipment to its previous operational state, but an engine overhaul for the same loader (cost \$15,437) was an improvement because it extended the life of the equipment (*Jacks v. Commissioner*, 55 T.C. Memo. 968 (1988)).

Note to Examiner: Use the current RGS lead sheet for audit steps.

Meals and Lodging

If the requirements under IRC section 119 are met, meals and lodging furnished to an employee for the employer's benefit (the lodging must be accepted as a condition of employment), may be excluded from income by the employee. The farmer may deduct the expense as a business expense.

A farmer who incorporates the farming operation and continues to operate the business becomes not only the employer, but also the employee. Therefore, the farmer/employer can furnish meals and lodging to the farmer/employee and claim a deduction for it. Treas. Reg. section 1.119-1(c)(2) provides that IRC section 119 is applicable only to meals furnished "in kind" by the employer. The IRS has taken the position that the term in kind refers only to meals prepared for consumption, and does not include groceries furnished to the employee (Rev. Rul. 77-80).

Meals are further limited by IRC section 274(n)(1) to 50% of the total expense. Meals must be furnished on the business premises of the employer (*TC Memo 2000-330, 80 TCM 577*). Meals must be furnished and can not be reimbursed. Meals should be made available to all employees without discrimination.

Lodging furnished to an employee for the convenience of the employer includes the value of any necessary utilities (for example, electricity, gas, water and sewage service). Telephone service was not necessary to make employer provided lodging habitable (*TC Memo 1981-211, 41 TCM 1384*). The utilities must be furnished by the employer to the employee. An employee may not contract with the utility supplier directly (Rev. Ruling 68-579, *TC Memo 1981-211, 41 TCM 1384*).

Note to Examiner: Use the current RGS lead sheet for audit steps.

Personal Living Expenses

The law specifically prohibits the deduction of certain personal living expenses. Since a farmer generally lives on the farm, these expenses might be deducted somewhere on Schedule F. These nondeductible expenses can include, but are not limited to:

- Rent and insurance premiums paid on property used as a residence;
- Life insurance premiums on the farmer or the farmer's family;
- The cost of owning and maintaining vehicles or horses for personal use;
- Allowances to children;
- Attorney's fees and legal expenses incurred for personal matters;
- Household expenses; and
- The cost of purchasing or raising produce or livestock consumed by the farmer's family.

Many of the checks a farmer writes for expenses during the year can be partially business and partially personal. These may include amounts paid for gasoline, oil and fuel, water, rent, electricity, automobile upkeep, insurance, interest, and taxes. The personal portion of these expenses is not deductible and must be allocated. Be particularly alert for payments to co-ops or farm stores, where a portion of the amount might be personal (for example, dog and cat food, clothing, groceries, etc.).

Examination Techniques

During the initial interview it is important to have a clear understanding of the farmer's life-style, the ages of any children, and utilities used, to determine a reasonable allocation of business and personal expenses. There are no specific guidelines for percentages to be used in allocating expenses. The farmer has the responsibility to demonstrate that the allocations are reasonable based on the facts.

Soil and Water Conservation Expenses

Occasionally, an issue arises regarding a farmer's expensing of costs associated with leveling or otherwise preparing land for use. Most of these questions have been resolved by IRC 175. The Regulation provides further clarification on this issue.

Internal Revenue Service Publication 225 provides information regarding the basis of assets. A farmer can elect to deduct expenses incurred for either soil or water conservation or for the prevention of erosion of land used in farming under IRC section 175. If no election is made, these expenditures must be added to the basis of the land. Once the farmer makes this expense election, it becomes the only method available to claim soil and conservation expenses. If the farmer ceases farming or dies before the entire cost has been deducted, the amount that has not been deducted is lost forever. It cannot be added to the basis of the land to reduce any gain on the sale of the farm. Approval from the IRS must be received to change reporting methods.

If you sell your farm, you cannot adjust the basis of the land at the time of the sale for any unused carryover of soil and water conservation expenses (except for deductions of assessments for depreciable property). However, if you acquire another farm and return to the business of farming, you can start deductions again for the unused carryovers.

Gain from the disposition of farm land held for nine years or less is subject to recapture as ordinary income. The amount recaptured may not exceed the lesser of the gain realized or a percentage of the total deductions claimed for soil and water conservation expenditures.

If the farm land is held for five years or less, the recapture percentage is 100 percent. The recapture percentage is 80 percent for a disposition within the sixth year after acquisition. For dispositions within the seventh, eighth, and ninth years after acquisition, the recapture percentages are 60 percent, 40 percent, and 20 percent, respectively. There is no recapture for property held more than nine years.

Example: Farm land is sold within the ninth year after acquisition at a \$40,000 gain. Total post-1969 deduction claimed for soil and water conservation expenditures regarding such farm land is \$15,000. The recapture percentage is 20% because the farm land was sold within the ninth year after acquisition. Accordingly, \$3,000 (20% of \$15,000) of the \$40,000 gain is treated as Code Sec. 1252 ordinary income.

The recapture covers only *deductible* soil and water conservation expenditures (see Code Sec. 175). Consequently, if deduction of these expenditures is limited because of the 25%-of-gross-farming-income limitation, only the deducted portion is recaptured (Code Sec. 175(b)). Similarly, there would be no recapture if the taxpayer capitalized his farm land expenditures.

The expenses for soil and water conservation must be consistent with a plan approved by the Soil Conservation Service (SCS). If no plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency to be deductible.

The annual deduction cannot exceed 25 percent of the farmer's gross income from farming. Any amount in excess of 25 percent may be carried over to later years.

Deductible expenses are those made with regard to land that is currently or was previously used for farming by the farmer or the farmer's tenant. The use of the land for farming can be either at the time of, or before the expenditures are made. It is important to differentiate between soil and water conservation expenditures and land clearing costs. Soil and water conservation expenditures include, but are not limited to:

- Treating or moving earth (for example, leveling, conditioning, grading, terracing, contour furrowing, or restoration of fertility);
- Constructing, controlling, and protecting diversion channels, drainage ditches, irrigation ditches, earthen dams, water-courses, outlets, and ponds;
- Eradicating brush; and
- Planting windbreaks.

The agent may want to utilize the Conservation Expense Lead Sheet for this issue.

Land Clearing Expenses

Prior to the Tax Reform Act of 1986, land clearing expenses could be deducted per IRC section 182. This section was repealed. Land clearing expenses are added to the basis of property.

Basis and Sales of the Farm and Farm Assets

Background

Tax management begins when a farm is purchased. Decisions made on allocation of the purchase price will affect the amount of income tax paid when the farm is sold. If the farm is transferred to children or other beneficiaries, these decisions will affect the income tax status of those receiving the farm.

When buying a farm, a new owner acquires a collection of assets including land, buildings, fences, and often, natural materials such as timber or gravel. An agreement as to the allocation of the purchase price to the various assets can be entered into by the buyer and seller or the buyer and seller can complete Form 8594. Form 8594, if completed, is attached to each participant's federal income tax return for the year in which the sale occurred. The tendency on the part of the buyer and the buyer's tax return preparer is to inflate the basis of the depreciable assets and undervalue the nondepreciable assets, such as land and personal residences. Amounts allocated to depreciable property will be recovered relatively soon in the form of depreciation deductions. Larger amounts allocated to this property will result in larger depreciation deductions. For example, a farmer might allocate part of the purchase price of a piece of land to residual fertilizer (from previous applications which has not been depleted by crop production), claiming that although the residual fertilizer raised the cost of the land, it will be exhausted during crop production. By assigning part of the cost of the land to residual fertilizer, the farmer lowers the cost of the land, which is nondepreciable. The IRS has denied such deductions when the farmer was unable to provide data indicating the level of soil fertility attributable to the previous owner. The farmer should be able to prove beneficial ownership of the residual fertilizer supply, the presence and extent of the residual fertilizer, and that the residual fertilizer is, in fact, being exhausted.

Determine if the value assigned to each asset acquired on the farm is reasonable. The most widely used and accepted examination technique to determine fair market value (FMV) is reliance on property values established by the county assessor's office. These values are available to the public. Every building on a tract of land is assigned a value by the county assessor. Land improvements (tile, fence, water wells) are usually not valued. Remember that trying to determine FMV is usually subjective.

Basis of Farm Assets³

Basis plays an integral part in determining gain or loss on the liquidation of a farm business. A gain or loss should be determined for each item of property sold by comparing its selling price to its adjusted basis. Basis is the value a property owner can recover as a lump-sum when that property is sold, or can charge off as an annual deduction through depreciation. The original basis is changed through capital improvements or by claiming deductions such as depreciation and casualty losses.

³*Internal Revenue Service Publication 225 - Chapter 6 provides information regarding the basis of assets.*

When property is purchased, its basis equals cost. This includes the cost of the property plus charges for freight, installation, and other expenses incurred in securing the property and preparing it for service. When land is purchased, basis includes the purchase price plus legal and recording fees, abstract fees, surveys, and payments for nondepreciable permanent improvements.

The way property is acquired determines its basis. Property can be purchased, acquired in a trade, received as a gift, or inherited.

Property Acquired in Trade

When property is acquired through a like-kind exchange, (for example, a trade), the gain or loss is deferred. The basis of such property is equal to the basis of the property exchanged plus any cash paid. For example, if a tractor with an adjusted basis of \$25,000 is traded for another tractor plus \$10,000 cash, the tractor acquired has a basis of \$35,000.

If cash is received instead of paid during an exchange, or the property is not like-kind, the result is a partially nontaxable transaction. In this case, computing basis requires adjusting the basis of the old property. The basis of the property acquired is the basis of the old property, reduced by money received or any loss recognized on the trade, and increased by additional costs incurred or any gain recognized on the exchange.

A farmer preparing to retire may start disposing of farm assets by the use of nontaxable exchanges. Such an exchange could involve more than one type of property and basis must be divided among the properties received in the exchange. The basis of any unlike property is its FMV on the date of the exchange. The balance of basis is then allocated to the like-kind property.

Example 1

Mark Sutter has a basis of \$40,000 in real estate held as an investment. The property is traded for a different tract of real estate with FMV of \$35,000 plus a truck with FMV of \$6,000, plus \$2,000 in cash. A \$3,000 gain is realized on the trade. The basis in the properties received is calculated as follows:

Basis of Properties Received	
Basis of real estate transferred	\$40,000
Minus: cash received	\$(2,000)
Plus: gain recognized	\$3,000
Basis of properties received	\$41,000

The \$41,000 must be divided between the real estate received and the truck. The truck's FMV is \$6,000 and that much basis must be allocated to the truck because the truck is

unlike kind property exchanged. The balance of property basis ($\$41,000 - \$6,000 = \$35,000$) is allocated to the real estate received.

Trading farm property can produce substantial tax savings by protecting part or all of the gain from immediate taxation. The following explains some of the basic rules of non-taxable trades.

1. Both real estate and personal property used in the business qualify for nontaxable exchanges.
2. The property involved must be held “for productive use in a trade or business or for investment.” Qualifying farm property includes: farmland and buildings; draft, breeding, and dairy livestock; and equipment.
3. Like-kind property must be exchanged. For business real estate, the like-kind rule is flexible: the farmer may exchange any income producing real estate. Farm real estate may be exchanged for a city apartment, timberland, or other real estate used to produce income.

Note: For personal property, the like-kind rule is more restrictive. The farmer may trade only dairy cows for other dairy cows; only farm equipment for other farm equipment. Livestock producers assume they can trade heifers for steers, but the law specifically states that heifers and steers are not like-kind properties.

4. The trade can be a multi-party exchange.

Example 2

Ann Tate owns property which she wants to exchange for property owned by Chuck Mitchell. Doug Weber wants to buy Ann's property. The parties in this situation may accomplish a like-kind exchange qualifying for nonrecognition treatment. Using a three party exchange, Doug can buy Chuck's property and transfer this property to Ann in exchange for Ann's property.

This transaction is allowed tax-free treatment even though Ann located the exchange property, which Doug then bought from Chuck solely for the purpose of the exchange.

5. The property acquired must be used for business or investment. If a farm is traded for city rental property and the city property is immediately sold, the trade does not qualify as nontaxable.

If during a trade, cash is received, or if the property traded or received is mortgaged, part of the gain may be recognized and taxable immediately.

Example 3

Tim Harris trades a farm for an apartment house. No cash is exchanged, but in the trade Tim is relieved of a \$20,000 mortgage on the farm. Tim assumes no mortgage on the

apartment house. For tax-reporting purposes, Tim is treated as if he had received \$20,000 in cash.

6. See the new regulations issued under IRC section 1031 for details regarding: meeting the like-kind requirement (same general asset class or same product class); identifying and exchanging property rules; and the use of a qualified intermediary.

Property Received as a Gift

In order to determine the basis of property, the following information needs to be determined:

1. The original owner's basis in the property just before the transfer;
2. The FMV of the property when given; and
3. The amount of gift tax paid.

See the examples of basis of gifted property in the attached Chapter 6: Basis of Assets from Publication 225.

Inherited Property

The basis of inherited property is generally one of the following.

- FMV at the time of the decedent's death. If taxpayer's jointly own farm property, the surviving spouse is entitled to a stepped-up basis on only 1/2 of such property.
- FMV on the alternate valuation date. If the personal representative for the estate elects to use alternate valuation.
- The decedent's adjusted basis in land to the extent of the value that is excluded from the decedent's taxable estate as a qualified conservation easement.

If a Federal estate tax return DOES not have to be filed, the basis in the inherited property is the appraised value at the date of death for state inheritance or transfer taxes.

Selling the Farm

Selling a farm involves disposing of both business and nonbusiness property. Land, machinery, livestock, and other assets used in farming are business property, while the farm residence is nonbusiness property. For each type of property, the tax treatment is different. Gains and losses may be either capital or ordinary depending upon the asset.

Selling the Farm Residence

Farmers are eligible to exclude gain realized from the sale or exchange of a principal residence under the following conditions:

- The farmer (taxpayer) has owned and used the home as his/her personal residence for at least 2 of the last 5 years;
- The farmer has not used the exclusion in the last 2 years; and
- The gain on the residence does not exceed \$250,000 (\$500,000 on a joint tax return). IRC section 121.

Although not conclusive, provisions in the contract of sale may be evidence as to the value of the residence, particularly if the transaction is between non-related parties. Also note, when the underlying farm land is sold and the principal residence is retained and the house moved to another lot, the gain realized on the land where the house was originally located is not excludable.

Land adjacent to the personal residence and not used in farming is includable as part of the personal residence. The amount of land that can be allocated to the personal residence has been the subject of court cases and should be researched for current guidance.

Losses on the sale of a farm residence are personal, and therefore, are not tax deductible. If a farm is sold for a single price under circumstances where a loss would be sustained on the residence portion, the transaction should be treated as two separate sales, the residence and the rest of the farm. The loss on the residence portion would be nondeductible.

Standing Crops Sold With a Farm

The sale of unharvested crops with a farm reduces the tax obligation for some farmers, since the crops acquire capital gain status (See IRC section 1231). To qualify for capital treatment the unharvested crops must be sold with the land and meet the following requirements:

1. Land must have been held more than one year and be used in the taxpayer's business of farming;
2. The crop and land must be sold at the same time and to the same person; and
3. The seller does not retain a right or option to reacquire the land, unless this right occurs as a part of a security interest in a mortgage.

The crop's stage of maturity does not affect its capital gain status. A crop at any stage, as long as it is unharvested, qualifies.

When unharvested crops are sold with the land and the seller seeks capital gain treatment, the cost of producing the crops must be treated as a capital investment, not as an operating expense. Crop production costs should be added to the basis of the property and excluded from farm operating expenses. Crop production costs include all cash expenses and fixed overhead costs, such as depreciation (IRC section 268).

Remember that if the farmer "elected out" of IRC section 263A on an orchard or vineyard, it is treated as IRC section 1245 property. This means that if there is any gain

when it is sold, you must recapture the preproductive expenses that would have been capitalized except for the "election". This is when having local cost studies of establishing orchards and/or vineyards is useful to either support the farmer's estimates or to use if records are not available.

Depreciation

Introduction

Farming is a capital intensive industry requiring heavy cash outlays for machinery and equipment. A farmer is allowed cost recovery or depreciation on machinery, equipment, and buildings. Depreciation is also allowed on purchased livestock acquired for dairy, breeding, draft, and sporting purposes, unless the farmer uses the accrual method of accounting and livestock is included in inventory. A significant expense on farm returns is depreciation.

MACRS Depreciation

The depreciation rules unique to farming are:

- Depreciation on farm property placed in service after 1988 is, generally, limited to 150% declining balance;
- Farm buildings (except single purpose agriculture or horticulture structures within the meaning of IRC section 168(1)(13) are assigned a 20-year recovery period); and
- Temp. Reg. 1.274-6T(b) allows a farmer to claim 75% business use of a vehicle without substantiation if the vehicle is used most of the normal business day directly in connection with the business of operating a farm. (i.e. cultivating land or raising or harvesting any agricultural or horticultural commodity, or the raising, shearing, feeding, caring for, training or managing animals, or incidental thereto, trips to feed and supply stores.) .

The same depreciation rules apply to farming as to any other business. Under MACRS (GDS) General Depreciation System, the recovery periods are 3, 5, 7, 10, 15, and 20 years. In addition, most real property is classified as either residential rental, or nonresidential (commercial) real property, with assigned recovery periods of 27.5 and 39 years respectively. For nonresidential real property acquired before May 13, 1993, the recovery period is 31.5 years. However, farm buildings, such as barns and machine sheds, are assigned a 20-year recovery period.

For personal property placed in service after 1988 in a farming business, a farmer must use the 150% declining balance method over a GDS recovery period or can elect one of the following:

- The straight line method over a GDS recovery period; or
- The straight line method over an ADS (Alternative Depreciation System) recovery period.

Note: Vineyards and orchards are limited to straight-line depreciation over a 10 year recovery period. ADS is required for farmers who elect not to apply the uniform capitalization rules to fruit or nut trees or vines produced in the farmers business that have a preproductive period of more than 2 years.

Alternative Minimum Tax (AMT) Adjustment

For property placed in service after 1998, a separate AMT adjustment is no longer required to be computed for the following:

- Residential rental property placed in service after 1988;
- Nonresidential real property with a class life of 27.5 years or more and other 1250 property placed in service after 1998 that is depreciated for regular tax using the straight line method;
- Property (other than section 1250 property) placed in service after 1998 that is depreciated for regular tax using the 150% declining balance method or the straight line method;
- Property for which you elected to use the alternative depreciation system (ADS) for regular tax;
- Any part of the cost of property for which the section 179 election is made; and
- Qualified property that is eligible for the special depreciation allowance (30% or 50% SDA) if the depreciable basis of the property for AMT is the same as for the regular tax. Property for which an election is in effect to not have the special allowance apply is not qualified property.

Depreciation must be refigured for AMT for the following:

- Property placed in service after 1998 that is depreciated for regular tax using 200 % DB MACRS;
- Section 1250 property placed in service after 1998 that is NOT depreciated for regular tax using the straight-line method; and
- Tangible property placed in service after 1986 and before 1999.

Section 179 Election

The section 179 deduction can be claimed on purchased (new or used) tangible, depreciable property that qualifies as section 1245 property. An election can be made to expense the cost or part of the cost of section 179 property in the year the property is placed in service.

The property must be acquired by purchase from an unrelated party and used more than 50% in a trade or business under IRC section 162. The cost of section 179 property that is satisfied by the trade of other property is not deductible under IRC section 179, i.e. cash paid (boot) satisfies the deductibility requirements of section 179 (Treas. Reg. section 1.179-4(d)). Property used in IRC section 212 activities, such as investment and rental activities, does not qualify. Section 179 does not apply to estates and trusts (IRC section 179(d)(4)). Property leased in a short-term rental activity can qualify as section 179 property if the restrictive requirements of section 179(d)(5) are met (Treas. Reg. section 1.179-4(e)). Placed in service means the time when the property is in a state of readiness and is available for its specific function. Property is first placed in service in the year the taxpayer first uses the property for any purpose (including personal use). If the property is not used for business in the first year, or the business use in the first year is not greater than 50%, the property does not qualify as section 179 property. Conversion to business use, or an increase to greater than 50% business use in a later year, will not qualify the property.

Dollar limits apply to the section 179 election amount. Special increased limitations apply to New York Liberty Zone and Gulf Zone property. The business taxable income limitation applies to the 179 deduction in each tax year. The section 179 election amount in excess of the business taxable income limit can carry forward indefinitely.

The section 179 election amount reduces the depreciable basis of the property. Any regular depreciation deductions are allowable on the remaining basis. On disposition, basis is increased by unused carryovers and section 179 recapture amount.

For purposes of determining whether the mid-year or mid-quarter convention is used to compute MACRS depreciation, the taxpayer may use the section 179 election to reduce the basis of qualifying property placed in service in the 4th quarter of the year. The 40% test is based on the depreciable basis after the reduction for the section 179 election.

Qualifying Property

(Treas. Reg. section 1.179-4(e)). Relating to farming, IRC section 1245 property includes the following:

- Tangible personal property such as machinery, equipment, tools, and trucks. It includes automatic feeders, barn cleaners, and office equipment. This does not include buildings and structural components.
- Other tangible property or bulk storage facilities for fungible commodities. For example:
 - Fences used in connection with raising livestock;
 - Paved feedlots;
 - Water wells that provide water for poultry, livestock or irrigation of crops;
 - Drainage tile;
 - Groves, orchards, and vineyards if productive (Exempt from IRC section 179 per Rev. Rul. 67-51);

- Grain bins, gas storage tanks, corn cribs, silos, milk tanks.
- Livestock (purchased but not raised) horses, cattle, hogs, sheep, goats, and mink and other fur-bearing animals. Treas. Reg. section 1.1245-3.
- Single purpose livestock or horticultural structures.

Excepted Property: The following properties do not qualify for the section 179 deduction:

- Intangible;
- Buildings and structural components;
- Property leased to others (this rule does not apply to corporations);
- Property used predominantly to furnish lodging or in connection with the furnishing of lodging;
- Property acquired by gift or inheritance;
- Property purchased from a related party. For this purpose, related parties include the farmer's spouse, ancestors, and lineal descendants, corporations and partnerships in which the farmer has more than a 50% interest. Also included are trusts and estates (IRC section 267(b));
- Energy Property; and
- Property used predominantly for investment use.

IRC Section 179 Election: For tax years beginning after 2002 and before 2010, a taxpayer can make a retroactive election to claim the section 179 deduction. Before 2003 and after 2010, the election must be made on the original return, whether or not timely filed, or on an amended return made by the due date of the return.

The election to take the section 179 deduction is made by completing Part 1 of Form 4562. For listed property Part V of Form 4562 is completed before Part 1. The election can be made on the original return or an amended return filed within the time prescribed by law which is generally, three years from the filing of the original return.

Election on amended return: An election made on an amended return must specify the item of section 179 property to which the election applies and the part of the cost of each item to be taken into account. The amended return must also include any resulting adjustments to taxable income for depreciation claimed.

Revoking an election: An election may be revoked without IRS approval by filing an amended return within the time prescribed by law. The amended return must also include any resulting adjustments to allowable depreciation and taxable income in that tax year for the item of section 179 property for which the election pertains. Once made, the revocation is irrevocable.

Dollar Limits: The maximum section 179 deduction is adjusted for inflation each year and is \$108,000 for 2006; \$125,000 for 2007; and \$250,000 for 2008. This limit is reduced by the amount by which the cost of section 179 property placed in service in the tax year exceeds \$430,000 for 2006; \$500,000 for 2007 and \$800,000 for 2008. For farmers with qualified Gulf Opportunity (GO) Zone property see Publication 946.

Business Taxable Income Limitation: The section 179 deduction is limited to the taxable income from the active conduct of any trade or business during the year. In addition to net income or loss from sole proprietorship, partnership, or S Corporation, net income or loss derived from a trade or business also includes the following:

- Wages, salaries, tips, or other pay earned as an employee. Wage income is considered as income from a trade or business for this limitation (Prop. Treas. Reg. 1.179-2(c)(5)(iv);
- Section 1231 gains (or losses); and
- Interest from working capital from trade or business.

The computation of taxable business income excludes:

- The section 179 deduction;
- The self-employment tax deduction;
- Any net operating loss carryback or carryforward; and
- Any unreimbursed employee business expense.

Example

The section 179 deduction limits apply both to the partnership or S corporation and to each partner and shareholder. The partnership or S corporation determines its section 179 deduction subject to the limits. It then allocates the deduction among its partners or shareholders.

In 2007, Partnership P placed in service section 179 properties with a total cost of \$585,000. P must reduce its dollar limit by \$85,000 (\$585,000 - \$500,000). Its maximum section 179 deduction is \$40,000 (\$125,000 - \$85,000), and it elects to expense that amount. Because P's taxable income from the active conduct of all its trades or businesses for the year was \$50,000, it can deduct the full \$40,000. P allocates \$20,000 of its section 179 deductions and \$25,000 of its taxable income to John, one of its partners.

John also conducts a business as a sole proprietor and in 2007, placed in service in that business, section 179 property costing \$14,000. John's taxable income from that business was \$5,000. He elects to expense the \$20,000 allocated from P, plus the \$14,000 of his sole proprietorship's section 179 costs. However, John's deduction is limited to his business taxable income of \$30,000 (\$25,000 from P plus \$5,000 from his sole proprietorship). He carries over \$4,000 (\$34,000 - \$30,000) of the elected section 179 costs to 2008.

Carryover of Unused Deduction

Any disallowed section 179 deductions are carried forward to succeeding years for an unlimited number of years. Treas. Reg. 1.179-3(a).

Section 179 Recapture

Gains from the sale of section 179 assets are treated like section 1245 gains. The amounts expensed are recaptured as ordinary income in the year the asset is sold. The section 179 deduction is combined with depreciation allowed to determine the amount of gain reported as ordinary income on Part III of Form 4797. This also includes sales on the installment method.

Section 179 Excess Depreciation Recapture

When business use falls to 50% or below before the end of the recovery period, the farmer must recapture (add back to income) the difference between the section 179 deduction taken and the allowable depreciation on the section 179 election amounts.

The recapture amount is the IRC section 179 deduction taken less allowable depreciation on the IRC section 179 election amount. Allowable depreciation includes depreciation for the year of recapture and all prior years.

When computing the recapture amount, the unused section 179 carryover is not included in the section 179 deduction taken. Treas. Reg. section 1.179-3(f)(2). Upon recapture, the unused carryover expires. The recapture amount and unused carryover are added back to adjusted basis of the property. Excess depreciation is recaptured as ordinary income on Part IV of Form 4797 and included in income on Schedule F (Form 1040). Treas. Reg. section 1.179-1(e)(2).

The section 179 amount must also be recaptured on non-taxable disposition before the end of the recovery period such as a gift. Converting the use of property from use in a trade or business to use in the production of income will be treated as a conversion to personal use. Treas. Reg. section 1.179-1(e)(2).

If the recapture rules of both Treas. Reg. section 1.179-1(3)(2) and IRC section 280F(b)(2) apply to an item of section 179 property, the amount of recapture for the property is determined under section 280F(b)(2).

Example of 179 Excess Depreciation recapture rules:

In January 2005, Paul Lamb, a calendar year taxpayer, bought and placed in service section 179 property costing \$10,000. The property is not listed property. He elected a \$5,000 section 179 deduction for the property and also elected not to claim a special depreciation allowance. He used the property only for business in 2005 and 2006. During 2007, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

Recapture Amount	
Section 179 deduction claimed (2005)	\$5,000
Minus: Allowable depreciation(instead of section 179 deduction):	

2005	\$1,250	
2006	\$1,875	
2007 ($\$1,250 \times 40\%$ (business))	<u>\$500</u>	
Total Allowable Depreciation 2005 – 2007		<u>\$3,625</u>
2007 - Recapture amount		\$1,375

Paul must include \$1,375 in income for 2007.

Special Depreciation Allowance (SDA)

Under IRC section 168(k) for (new) qualifying property placed in service in 2008, an additional first year special depreciation allowance is required unless the taxpayer makes an election. The allowance is 50% of the property's depreciable basis (after any section 179 deduction and before figuring the regular depreciation deduction). Qualifying property for the special depreciation allowance includes: (1) Tangible property depreciated under (MACRS) with a recovery period of 20 years or less; (2) water utility property; (3) off-the-shelf computer software; or (4) qualified leasehold property.

The original use of the property must begin with the taxpayer in 2008. The property must be purchased and placed in service in 2008. For tangible personal property used to transport people or property and certain aircraft, the placed in service date is extended one year, through December 31, 2009.

Property that does not qualify for the special depreciation allowance includes: (1) Property placed in service and disposed of in the same year; (2) Property converted from business use to personal use in the same tax year it is acquired; (3) Property required to be depreciated under the alternative depreciation system (ADS); (4) Property included in a class of property for which the taxpayer elected not to claim the special depreciation allowance.

For farmers with qualified Gulf Opportunity (GO) Zone property acquired by purchase after August 27, 2005 see Publication 946.

Election not to Claim the Special Bonus Depreciation

An election can be made for any class of property, not to deduct any special allowances for all property in such class placed in service during the tax year. The election is made by attaching a statement to the tax return indicating what election is being made and the class of property for which the election is being made.

Listed Property

IRC section 280F limits the depreciation deduction that may be claimed on listed property placed in service after June 18, 1984. If not used predominantly (more than 50 percent) in a trade or business under section 162, the IRC section 179 deduction and special depreciation allowance on the property are denied. The property must be depreciated using the straight-line method over the ADS recovery period.

Listed property is property of a type that lends itself to personal use, including:

- Passenger automobiles;
- Any other property used for transportation;
- Property used for entertainment, recreation, or amusement;
- Computers and peripheral equipment;
- Cellular telephones and similar telecommunications equipment;

Certain types of special purpose farm vehicles, such as tractors and combines, are excluded from the application of the limitations because they are suited only for use in the farming operation.

Passenger automobiles include any four-wheel vehicle manufactured primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less unloaded gross vehicle weight. This includes cars, trucks, vans and SUV's. There are dollar limitation rules for the deduction that may be claimed each year for passenger automobiles. The dollar limits change yearly and can be found in Revenue Procedures. Refer to passenger automobile limit tables in Pub. 946.

Although vehicles rated at more than the 6,000 pound threshold are not passenger automobiles for the passenger automobile limits, they are still "other property used for transportation" and are subject to the special rules for listed property. Other property used for transportation includes trucks, vans, SUV's, buses, boats, airplanes, motorcycles, and any other vehicles used to transport persons or goods (*Sullivan v. Comm., T.C. Memo 2002-131*).

Vehix.com, under "detailed specifications", shows the rated gross vehicle weight for any year and model.

Passenger Automobile Limits: The maximum depreciation deduction (including section 179 deduction) for a passenger automobile (that is not a truck or van) used in a business and first placed in service in 2007 is \$3,060. For 2008, the limit is \$2,960 (\$10,960 for automobiles for which the special depreciation allowances applies).

The maximum depreciation deduction for a truck or van used in a business and first placed in service in 2007 is \$3,260. For 2008, the limit is \$3,160 (\$11,160 for trucks or vans for which the special depreciation allowance applies).

These limits are reduced if the business use of the vehicle is less than 100%.

Unrecovered Basis of Automobiles

Depreciation of listed property, other than automobiles, does not continue past the end of the recovery period. For passenger automobiles (with gross vehicle weight of 6,000 pounds or less), subject to the annual limits, the remaining basis (unrecovered basis) that is due to the limitation on the depreciation deduction, can be depreciated after the recovery period. Other remaining basis in the asset due to personal use during the recovery period cannot be depreciated. The unrecovered basis is the basis less the total allowed or allowable depreciation for the recovery period, assuming 100% business use, regardless of the actual percentage use in each year. This reduction to basis prevents deducting 100% of the cost of an asset which is only partially used for business (IRC section 280F(a)(1)(B)(i)).

Limits for Heavier Vans, SUVs, and Trucks: The maximum section 179 election for sport utility vehicles, heavier vans and trucks placed in service after October 22, 2004 is \$25,000. This rule applies to passenger automobiles that are not subject to the depreciation caps under 280F. Included are any 4-wheeled vehicle primarily designed or used to carry passengers over public streets, roads, and highways that is rated at more than 6,000 pounds gross vehicle weight and not more than 14,000 pounds.

Listed Property Excess Depreciation Recapture

If, in any year during the property's recovery period, the percentage business use drops to 50% or less, in the year the business use drops to 50% or less, excess depreciation is recaptured as ordinary income in Part IV of Form 4797 and included in income on Schedule F (Form 1040).

For listed property, the excess depreciation is: (1) the depreciation allowable for the property (including any section 179 deduction and special depreciation allowance claimed) for the years before the first year the property is not used predominately for a business use, minus; (2) The depreciation that would have been allowable for those years if it had not been predominantly used for qualified business use in the year it was placed in service. This amount is determined by refiguring the depreciation using the straight line method and ADS recovery period.

Note: this computation is more restrictive than the IRC section 179 excess depreciation recapture rule. If both recapture rules apply to an item of property then IRC section 280F is used to determine the recapture amount.

Example of excess depreciation recapture under IRC section 280F. To determine excess depreciation recapture, you must refigure the depreciation using the straight line method and the ADS recovery period.

In June 2003, Ellen Rye purchased and placed in service a pickup truck that cost \$18,000. She used it only for qualified business (farm) use for 2003 through 2006. Ellen claimed a section 179 deduction of \$10,000 based on the purchase of the truck. She began

depreciating it using the 150% DB method over a 5-year GDS recovery period. The pickup truck's gross vehicle weight was over 6,000 pounds, so it was not subject to the passenger automobile limits. During 2007, she used the truck 50% for business and 50% for personal purposes. She includes \$3,401 excess depreciation in her gross income for 2007. The excess depreciation is determined as follows.

Excess Depreciation		
Total section 179 deduction (\$10,000) and depreciation claimed (\$6,001) for 2003 through 2006. (Depreciation is from Table A-1.)		\$16,001
Minus: Depreciation allowable (Table A-8):		
2003 - 10% of \$18,000	\$1,800	
2004 - 20% of \$18,000	\$3,600	
2005 - 20% of \$18,000	\$3,600	
2006 - 20% of \$18,000	<u>\$3,600</u>	
Total Allowable Depreciation 2005 – 2007		<u>\$12,600</u>
Excess depreciation		\$3,401

If Ellen's use of the truck does not change to 50% for business and 50% for personal purposes until 2009, there will be no excess depreciation. The total depreciation allowable using Table A-8 through 2009 will be \$18,000, which equals the total of the section 179 deductions and depreciation she will have claimed.

Where to Figure and Report Recapture

Use Form 4797, Part IV, to figure the recapture amount. Report the recapture amount as other income on Schedule F.

Examination Techniques and Procedures

- Review the depreciation schedule to verify the 150% limitation was applied. Review recovery period and method.
- Consider allowed or allowable rule for basis adjustments. Application of this rule can result in adjustments to basis when a farmer has used a longer recovery than the 20-year recovery period assigned to farm buildings.
- When the taxpayer or spouse has an off-farm job or children who are driving age, determine what vehicles they drive. These vehicles may be at off-farm jobs, school or even away at college and not being used at all or very little for farm use.
- Review prior year detailed depreciation schedules and tax returns to determine if the section 179 deduction was claimed on personal use vehicles which were then removed or never included on the detailed depreciation schedule.

Publication 225, Table 7-1. Farm Property Recovery Periods

Recovery Period		
	Recovery Period in Years	
Assets	GDS	ADS
Agricultural structures (single purpose)	10	15
Automobiles	5	5
Calculators and copiers	5	6
Cattle (dairy or breeding)	5	7
Communication equipment ¹	7	10
Computer and peripheral equipment	5	5
Drainage facilities	15	20
Farm buildings ²	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Goats and sheep (breeding)	5	5
Grain bin	7	10
Hogs (breeding)	3	3
Horses (age when placed in service)		
Breeding and working (12 years or less)	7	10
Breeding and working (more than 12 years)	3	10
Racing horses (more than 2 years)	3	12
Horticultural structures (single purpose)	10	15
Logging machinery and equipment ³	5	6
Nonresidential real property	39 ⁴	40
Office furniture, fixtures, and equipment (not calculators, copiers, or typewriters)	7	10

Recovery Period		
	Recovery Period in Years	
Assets	GDS	ADS
Paved lots	15	20
Residential rental property	27.5	40
Tractor units (over-the-road)	3	4
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 lbs. or more)	5	6
Truck (actual weight less than 13,000 lbs)	5	5
Water wells	15	20
¹ Not including communication equipment listed in other classes. ² Not including single purpose agricultural or horticultural structures. ³ Used by logging and sawmill operators for cutting of timber. ⁴ For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.		

For property placed in service before 1999, you could have elected to use the 150% declining balance method using the ADS recovery periods for certain property classes. If you made this election, continue to use the same method and recovery period for that property.

Real Property

You can depreciate real property using the straight line method under either GDS or ADS.

Switching To Straight Line

If you use a declining balance method, you switch to the straight line method in the year it provides an equal or greater deduction. If you use the MACRS percentage tables, you do not need to determine in which year your deduction is greater using the straight line method. The tables have the switch to the straight line method built into their rates.

Fruit or Nut Trees and Vines

Depreciate trees and vines bearing fruit or nuts under GDS using the straight line method over a 10-year recovery period.

ADS Required For Some Farmers.

If you elect not to apply the uniform capitalization rules to any plant produced in your farming business, you must use ADS for all property you place in service in any year the election is in effect.

Mineral and Water Rights

Review the schedule of capital assets. If mineral rights, including water rights, are on the schedule, how they were acquired needs to be questioned. Mineral rights can be acquired in various ways. They can be purchased along with the land or they can be bought and sold separately. If purchased as part of the land, review the allocation. If an allocation was made, there should be an appraisal from a geologist. Mineral rights are a capital asset similar to land. A farmer who owns an economic interest in producing mines: oil, gas, or geothermal wells, or any other natural deposits, such as gravel, sand and topsoil; or standing timber, may deduct a reasonable amount for depletion. Economic interest exists if the farmer has a legal right to receive income from the sale of natural resources. The farmer does not have an economic interest if there is only a right to buy or process the mineral deposits, or timber.

As long as a farmer continues to be the owner of the land, a loss cannot be claimed on worthless mineral rights. Any losses when the land is sold are capital losses.

Example

An oil company drills a test well that does not produce on land rented from a farmer. Assuming that the farmer owns the mineral rights, he would only be entitled to a capital loss on the mineral rights when the land is sold, not when the well stops producing. The situation is well described in *Louisiana Land & Exploration Co. v. Commissioner*, 161 F.2d 842 (5th Cir. 1947).

Depletion

There are two ways to figure depletion:

1. Cost Depletion method; and
2. Percentage Depletion method

Cost Depletion

To figure cost depletion, the property's basis for depletion is divided by the total recoverable units of mineral in the property's natural deposit. This cost per unit depletion figure is then multiplied by the number of units extracted and sold during the year to determine the amount of depletion deduction allowed for that year.

Cost depletion, for water rights, is allowed when it can be demonstrated that the ground water is being depleted and that the rate of recharge is so slow that once extracted, the water is lost to the farmer and to immediately succeeding generations. [See Rev. Rul. 82-214, 1982-2 C.B. 115 and Rev. Rul. 65-296, 1965-2 C.B. 181.]

Percentage Depletion

This method may not be used for standing timber, soil, sod, dirt, water, or turf. To compute percentage depletion, multiply the property's gross income for the tax year by the depletion percentage for that type of property. The percentage depletion deduction cannot be more than 50% of the property's taxable income determined without the depletion deduction and any net operating loss deduction.

For tax years beginning before January 1, 2005, the percentage for oil and gas properties was limited to 100% of the taxable income from the property (computed without the allowance for depletion). For tax years beginning after December 31, 2004, the taxable income is computed without the allowance for depletion and without the deduction under IRC section 199. For tax years beginning after December 31, 1997 and before January 1, 2008, the 100% taxable income limit on percentage depletion deductions for oil and gas properties is suspended for marginal properties [IRC section 613A(c)(6)(H)]. The 50% limitation still applies to all other depletable properties (IRC section 613). This distinction is important because farmers often have oil and gas interests.

Depletion Recapture

Depletion is subject to recapture as ordinary income upon the sale or other disposition of oil, gas, geothermal or other mineral property at a gain (IRC section 1254). Recapture is limited to the amount by which the depletion deduction reduced the adjusted basis of the disposed property.

If the farmer has sold farmland on which water depletion was taken, the basis of the farmland must be adjusted by any cost depletion deductions claimed in prior years. Prior year returns should be inspected for any water depletion deductions.

Consider the following when water depletion expense is present:

1. How was the ground water acquisition valued?
2. What is similar land selling for that does not have a good water supply?
3. Has the farmer sold farmland on which water depletion was taken? If so, has the basis of the farmland been adjusted by any cost depletion deductions claimed in prior years.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Sales of Livestock

Background

Farmers may have more than one source of income from the farm. Some grain producers feed part of their raised corn, milo, and/or hay crops to their livestock. Thus, it is important to ascertain if a grain producer also has a livestock operation. By using raised crops as livestock feed, the farmer saves on handling and shipping costs of grain to be sold and saves on the cost of purchased livestock feed.

Corn and milo fields will have some grain the combine cannot retrieve. This is an additional, inexpensive way to pasture and feed cattle in the fall and winter. The farmer may also rent the stubble to another farmer. Farmers may buy feeder calves to pasture on the stubble or on pasture ground. These purchased animals may be purchased and sold in the same year because the farmer does not have grain to feed to the cattle through the winter months. Corn and hay crops would most likely be fed to purchased feeder cattle. Corn and milo crops could be fed to feeder pigs. Soybean stubble and harvested soybeans are not fed to livestock. The farmer who has substantial land in pasture and hay could also have a cow/calf breeding operation to utilize the pasture. A cow/calf operation is ranching, which is not included in this guide. Nonetheless, some information on ranching is necessary, since some grain producers may have a breeding herd. A hog breeding operation does not require land in pasture and hay, but does require grain.

The type of livestock sold determines where the sale will be reported on the tax return. Income from all livestock held primarily for sale is reported on Schedule F. Receipts from the sale of raised calves or hogs are entered on Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of Schedule F. A cash basis farmer deducts the purchase price in the year of sale on Part I of Schedule F, Treasury Regulation section 1.61-4, while an accrual basis farmer takes the deduction on Part III of Schedule F. Sales of livestock held for draft, breeding, or dairy purposes are reported on Form 4797 and can ultimately be reported on Schedule D.

Sale of Items Bought For Resale

Like other taxpayers in a trade or business, the farmer can purchase items which will be sold later. In the retail trade this would be inventory. For the farmer, these purchases can include such things as feeder calves and feeder pigs. Feeder calves are young beef cattle weighing around 500 pounds, which the farmer will feed and raise until they are ready to be sold. The weight at which the calves are sold depends on whether the farmer is back grounding the cattle (putting them on pasture until they weigh 700 - 900 pounds), or holding them all the way through the feedlot to slaughter, at which time they would weigh 1,000 to 1,200 pounds. Feeder pigs are young swine weighing about 50 pounds when purchased, and are raised by the farmer until they reach market weight (200 to 240 pounds), at 6 to 9 months of age. Purchases of livestock for subsequent resale represent the largest category of items purchased for resale.

A unique difference between farmers and other businesses involves items purchased for resale. In other industries the IRS requires the taxpayer to use inventories and the accrual method of accounting to report income from the sale of purchased goods. A farmer may elect to use inventories and the accrual method of accounting, or the cash receipts and disbursements method. To the cash basis farmer, cattle and hogs purchased to be fed and resold are not technically inventory. This creates a unique bookkeeping problem. The purchase cost is treated as a deferred cost under IRC section 61, to be deducted on Schedule F upon the sale of the livestock. Other acquisition costs such as trucking and commissions should also be capitalized and added to the cost of the livestock (Rev. Rul. 80-102). The farmer must match the cost of the purchased items to the sale of those items. The potential for a double deduction of these items in 2 years is high. Remember, the cost of cattle or hogs is reported on Schedule F to determine the profit realized on the sale of the livestock and is shown on the return in the year that the sale is reported.

Examination Techniques

- The cost of items purchased near the end of the year may be deducted on the Schedule F, even though they are on hand at the year's end and actually sold the following year. The expense could be deducted again when the items are sold. Purchases in the last 6 months of the year and sales in the first 6 months of the subsequent year should be scrutinized to verify that purchases were properly deducted in the year of sale.
- Deferred payment contracts or installment sales of items purchased for resale and the costs associated with those sales should be examined to ensure that the costs are not claimed before the income is reported.
- Death losses on purchased livestock can be deducted at cost in the year of death. Be sure the deduction is not taken twice (for example in the year of death and again when the remaining livestock is sold). No deduction is allowed for death losses of raised livestock.

Note to Examiner: Use the current RGS lead sheet for audit steps.

Sale of Livestock Held For Draft, Breeding or Dairy Purposes

Livestock and dairy farmers often purchase breeding and dairy animals whose costs are depreciable on Form 4562, Depreciation and Amortization Schedule; however, livestock and dairy farmers may use animals they have raised for breeding and dairy purposes. Purchased breeding and dairy animals are depreciable while raised animals are not.

It is important to differentiate between livestock held primarily for sale in the ordinary course of business, and livestock held for draft, breeding, dairy, or sporting purposes. Sales of livestock held primarily for sale in the ordinary course of business are always reported on Schedule F, while sales of livestock held for draft, breeding, dairy, or sporting purposes are properly reported on Form 4797. This is true regardless of whether

the animals are purchased or raised. Farmers may try to report livestock held for resale on Form 4797 to avoid self-employment tax on those sales.

The holding period of draft, breeding, dairy, or sporting animals determines where on Form 4797 these sales are reported. The holding period for horses and cattle “used in the farming business” is more than 2 years (IRC section 1231). The holding period for all other livestock used in the farming business is more than 1 year. Breeding hogs (sows and boars) are the most common livestock in the more than 1 year category. If the holding period is not met, the gain or loss on the sale of livestock used in the farming business must be reported in Part II, Form 4797, Ordinary Gains and Losses. If the holding period is met, the gain or loss will be reported in either Part I or Part III. The gain on the sale of purchased livestock meeting the holding period and used in the farming business should be reported in Part III. Part III is used to properly recapture any ordinary gain on depreciable purchased livestock under IRC section 1245. The gain or loss on all other livestock (purchased or raised) meeting the holding period and “used in the farming business” should be reported in Part I.

The following link will take you to the instructions for the Form 4797, which provides a useful chart to assist you in determining whether the sale is properly reported.

Instructions for Form 4797, Sale of Business Property

<http://www.irs.gov/pub/irs-pdf/i4797.pdf>

Distress Sales of Livestock Due To Weather-Related Conditions (Drought, Flood, Etc.)

The following link will take you to Publication 225, to the section for Sales Caused by Weather Related Conditions:

<http://www.irs.gov/publications/p225/ch03.html#d0e1748>

Livestock producers who are forced to sell animals because of a shortage of water or feed, or other consequences of a drought, flood or other related weather conditions may be able to postpone the recognition of income from the proceeds of those sales. IRC section 451(e).

There are two different tax treatments, both of which apply to drought, flood or other related weather conditions sales in excess of normal business practices.

- The first applies to draft, breeding, or dairy animals that will be replaced within a 2-year period, or if the loss occurred in a President declared disaster area, the replacement period is 4 years. IRC section 1033(e).
- The second applies to all livestock, and allows a 2-year postponement of the reporting of sales proceeds. Livestock destroyed or sold or exchanged because of disease are deemed to be treated as involuntarily converted. IRC section 1033(d).

Livestock Held for Draft, Breeding or Dairy Purposes (Tax Treatment #1)

If livestock (other than poultry) held for any length of time for draft, breeding, or dairy purposes is sold because of drought conditions, the gain realized on the sale does not have to be recognized, if the proceeds are used to purchase replacement livestock within 2 years from the end of the tax year in which the sale takes place.

Note: There is no required holding period for this provision as there is in IRC section 1231.

The new livestock purchased must be used for the same purpose as those sold due to drought, flood or other weather-related condition- breeding stock must be replaced with breeding stock, dairy cows with dairy cows, etc.

The farmer must show the drought, flood or other weather-related condition caused the sale of more livestock than would normally have been sold. Only the animals that would not have been sold can be replaced without recognition of gain. For example, if the farmer normally sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for this provision. Under this treatment, there is no requirement that the drought, flood or other weather-related condition conditions cause an area to be declared a disaster area by the Federal Government.

The farmer has a basis in the replacement livestock equal to the basis in the livestock sold, plus any amount invested in the replacement livestock that exceed the proceeds from the sale of the animals replaced.

The election to defer the recognition of gain by reducing the basis of the replacement livestock is made by attaching a statement to the tax return including the following:

- Evidence of the drought, flood or other weather-related condition conditions that forced the sale or exchange of the livestock
- A computation of the amount of gain realized on the sale or exchange
- The number and kind of livestock sold or exchanged
- The number of livestock of each kind that would have been sold or exchanged under usual business practices of the farmer with no drought, flood or other weather-related condition.

Example 1

Mary Ramsey normally sells 10 cows from her beef herd each year. In 2008, drought, flood or other weather-related conditions reduced her hay crop, so she did not have enough feed to carry her normal herd through the winter. Consequently, she sold 25 cows rather than 10 in 2008. She plans to purchase an additional 15 cows in 2009 to replace the extra 15 that were sold.

Only 15 of the cows sold in 2008 qualify for the deferral of gain due to drought, flood or other weather-related condition. Mary can elect to defer the gain by:

1. Not reporting the gain on those 15 cows on her 2008 tax return; and
2. Attaching the a statement claiming an election under IRC section 1033(e) to Postpone Recognition of Gain from Livestock Sold because of drought, flood or other weather-related condition.

The drought conditions evidenced by the rainfall report attached to this statement caused the taxpayer to sell 25 head of beef cows rather than 10 head in 2008. The raised cows have a zero basis. The 25 cows sold for a total of \$12,500. Taxpayer elects to defer the recognition of gain on the 15 extra head that were sold ($15/25 \times \$12,500 = \$7,500$ of gain) under IRC section 1033(e).

If Mary Ramsey reinvests \$7,500 on 15 replacement cows in 2009, she will have a zero basis in the replacement cows. If she reinvests more than \$7,500 in 15 cows, the excess will be her basis in the cows. If she reinvests less than \$7,500 in 15 cows, the excess of \$7,500 over the amount reinvested must be reported as income. If she only buys 14 cows in 2009 and 2010, \$500 of gain (for the cow not replaced) must be reported regardless of what she paid for the 14 cows. Mary should report the purchase of the replacement cows on her 2009 return. If there is additional income, it is reportable in 2008 by filing an amended return for that year.

Deferring Income to Subsequent Year (Tax Treatment #2)

If any livestock are sold because of drought, flood or other weather-related conditions, the farmer may be eligible for another exception to the general rule that the sales proceeds must be reported in the year received. This exception allows the farmer to postpone reporting the income by two years.

In order to defer the income to the next year the following conditions must be met:

- The taxpayer's principal business must be farming;
- The farmer must use the cash method of accounting;
- The farmer must show that the livestock would normally have been sold in the following year; and
- A drought, flood or other weather-related condition that caused an area to be declared a Federal disaster area must have caused the sale of livestock.

It is not necessary that the livestock be raised or sold in the declared disaster area, just that the drought, flood or other weather-related condition that caused an area to be declared a disaster area caused the sale of the livestock. Also, the sale can take place before or after an area is declared a disaster area as long as the same drought, flood or other weather-related condition caused the sale.

The number of animals that would normally be sold with no drought, flood or other weather-related condition is determined primarily by the past history of the farmer. If the farmer generally holds all calves until the year after they are born before selling them, but was forced because of drought, flood or other weather-related condition conditions to sell them in the year they were born, the proceeds from this sale may be reported in the year following the year of the sale. The computation for amount of income that can be postponed is shown in the following example:

Example 2

Because of drought, flood or other weather-related condition conditions, Beau Perry sold 750 head of sheep in 2008, instead of the 500 head he normally would sell. He received \$75,000 for the 750 head sold. He can postpone reporting the sale of only 250 sheep. The dollar amount is calculated by dividing the sale proceeds by the 750 sheep sold, and multiplying the result by the 250 for which he can postpone the proceeds. Therefore, $(\$75,000/750 \times 250)$, or \$25,000 can be reported in 2009, rather than in 2008.

The farmer has an option of reporting the income in the year of the sale or of electing to report the income in the following year. The election must be made by the due date of the return (including extensions) for the tax year in which the drought, flood or other weather-related condition sale occurred. The election is made by attaching a statement to the return that includes the following information:

- A declaration that the farmer is making an election under IRC section 451(e);
- Evidence of the drought, flood or other weather-related condition conditions that forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for Federal assistance as a result of the drought, flood or other weather-related condition conditions;
- A statement explaining the relationship of the designated drought, flood or other weather-related condition area to the early sale or exchange of the livestock;
- The total number of animals sold in each of the 3 preceding years;
- The number of animals that would have been sold in the taxable year had the farmer followed his or her normal business practice in the absence of drought, flood or other weather-related condition;
- The total number of animals sold and the number sold on account of drought, flood or other weather-related condition during the taxable year; and
- A computation of the amount income to be postponed for each class of livestock.

This election applies to all livestock held for sale, whether raised or purchased for resale. It also applies to livestock used for draft, breeding, dairy, or sporting purposes and held for less than 2 years in the case of cattle or horses, and less than 1 year for other livestock.

Therefore, a farmer has an option for draft, breeding, or dairy livestock and horses held less than 2 years or for other livestock held less than 1 year. The farmer can elect to defer the income to the subsequent year per tax treatment #2, or if the animals are replaced, the

farmer can exclude the gain on the sale, if the animals are replaced within 2 years of the end of the tax year of the sale, per tax treatment #1.

Examination Techniques

- Look carefully at sales receipts. Sales of steers can be reported on Form 4797 as breeding livestock, when they should be reported on Schedule F. Also, heifers held for resale might be reported as sales of breeding livestock. Weight can be an indication of age and use. If the weight of the heifer is less than 900 pounds, she has probably been held less than 24 months, and was most likely not held for breeding purposes. The sale should be reported on Schedule F. Look carefully at sales receipts.
- Some farmers use proceeds from sales of livestock to pay off loans used to acquire that livestock, or as payments on other farm or personal loans. The check from the sale is endorsed directly to the lending institution and might not be reported on the farmers' books as income. A farmer's liability ledger should be inspected, and the source of payments verified to determine that no sales proceeds from livestock or grain were used to pay debts and inadvertently omitted from income.

Since sales of livestock on the Form 4797 are not included in self-employment income, a farmer may report non-qualified livestock on Form 4797 to avoid self-employment tax.

Along the same lines, farmers might use the proceeds from the sale of livestock to pay off loans, to make down payments or totally acquire other assets, (for example, a pickup truck), and that sale could be omitted from income. Be sure and verify the source of all asset acquisitions.

- If the farmer has cattle in a feedlot, it is possible to duplicate the feedlot expenses on the tax return. The feedlot writes the farmer a net check on the sale of the feeder cattle. A net check is the gross sales price of the cattle, less feedlot expenses such as, feed, veterinary, yardage, interest, etc., and is the amount actually paid to the farmer on disposition of the cattle. Sometimes only the net check is reported as income, and a deduction is taken for all of the feedlot expenses. If the net check is reported as income, ensure that none of the expenses withheld from the sales proceeds are deducted.

Credits

Background

Like other businesses, the farmer is entitled to use various credits including general business credit and the fuel tax credit.

Fuel (Excise) Tax Credit

The fuel tax credit allows the farmer to avoid paying excise tax on gasoline and special fuels when the fuel is used for a nontaxable use. The fuel tax credit can present several examination issues. These issues include: claiming a credit when the farmer is not entitled to it; failing to report the credit as income; or claiming excess credits.

As of October 1, 2005, diesel fuel and kerosene are taxed in the same manner as gasoline. In general, the farmers that own, operate or rent a farm may claim the fuel tax credit for all fuels delivered to the farm with the tax included and used for a nontaxable use. The credit is determined by taking the number of gallons of fuel purchased (tax paid), and used for a nontaxable use, multiplied by the amount of tax per gallon. The primary matters to be resolved in this area during a farm examination are the following.

1. Was the fuel used for farm purposes, off-highway business use or as other than a fuel in a propulsion engine, such as home use?
2. How many gallons of fuel were actually used?
3. How many total gallons of fuel were purchased with tax included?

It is imperative to verify that the farmer is not claiming the credit on any fuel delivered tax free.

Nontaxable uses include:

- Use on a farm for farming purposes
- Off-highway business use
- Uses other than as a fuel in a propulsion engine, such as home use.

Farming Purpose

Fuel is used on a farm for farming purposes if it is used in carrying on the business of farming, on a farm in the United States, and for farming purposes.

Farm (defined) A farm includes the following; livestock, dairy, fish, poultry, fruit, fur-bearing animals, and truck farms, orchards, plantations, ranches, nurseries, ranges, and feed yards for fattening cattle. It also includes structures such as greenhouses used primarily for raising agricultural or horticultural commodities. A fish farm is an area where fish are grown or raised - not merely caught or harvested.

Farming purposes. The credit may be claimed by the owner, tenant, or operator as ultimate purchaser of fuel, who uses the fuel on a farm for farming purposes in any of the following ways:

1. To cultivate the soil or to raise or harvest any agricultural or horticultural commodity.

2. To raise, shear, feed, care for, train, or manage livestock, bees, poultry, fur-bearing animals, or wildlife.
3. To operate, manage, conserve, improve, or maintain your farm and its tools and equipment.
4. To handle, dry, pack, grade, or store any raw agricultural or horticultural commodity. For this use to qualify, you must have produced more than half the commodity so treated during the tax year. The more-than-one-half test applies separately to each commodity. Commodity means a single raw product. For example, apples and peaches are two separate commodities.
5. To plant, cultivate, care for, or cut trees or to prepare (other than sawing logs into lumber, chipping, or other milling) trees for market, but only if the planting, etc., is incidental to your farming operations. Your tree operations are incidental only if they are minor in nature when compared to the total farming operations.

If any other person, such as a neighbor or custom operator, performs a service for the farmer for any of the purposes included in list items (1) or (2), the farmer is considered to be the ultimate purchaser who used the fuel on a farm for farming purposes. The farmer can claim the credit or refund for the fuel so used. However, see *Custom application of fertilizer and pesticide*, later. If the other person performs any other services for the farmer for purposes not included in list items (1) or (2), no one can claim the credit or refund for fuel used on the farm for those other services.

Example

Farm owner Haleigh Blue hired custom operator Tyler Steele to cultivate the soil on her farm. Tyler used 200 gallons of undyed diesel fuel that he purchased to perform the work on Haleigh's farm. In addition, Haleigh hired contractor Brown to pack and store her apple crop. Brown bought 25 gallons of undyed diesel fuel to use in packing the apples. Haleigh can claim the credit for the 200 gallons of undyed diesel fuel used by Tyler on her farm because it qualifies as fuel used on the farm for farming purposes. No one can claim a credit for the 25 gallons used by Brown because they were not used for a farming purpose included in list items (1) or (2), earlier.

Buyer of Fuel, Including Undyed Diesel Fuel or Undyed Kerosene. If doubt exists whether the owner, tenant, or operator of the farm bought the fuel, determine who actually bore the cost of the fuel. For example, if the owner of a farm and his or her tenant equally share the cost of gasoline used on the farm, each can claim a credit for the tax on half the fuel used.

Undyed Diesel Fuel, Undyed Kerosene, and Other Fuels (Including Alternative Fuels). The farmer is the only person who can make a claim for credit or refund for the tax on undyed diesel fuel, undyed kerosene, or Other Fuels (including alternative fuels) used for farming purposes. Also see *Dyed Diesel Fuel and Dyed Kerosene*, later.

Custom Application of Fertilizer and Pesticide. Fuel used on a farm for farming purposes includes fuel used in the application of fertilizer, pesticides, or other substances,

including aerial applications. Generally, the applicator is treated as having used the fuel on a farm for farming purposes. For aviation gasoline, the aerial applicator makes the claim as the ultimate purchaser. For kerosene used in aviation, the ultimate purchaser may make the claim or waive the right to make the claim to the registered ultimate vendor.

A registered ultimate vendor is the person who sells undyed diesel fuel, undyed kerosene, or kerosene for use in aviation to the user (ultimate purchaser) of the fuel for use on a farm for farming purposes. To claim a credit or refund of tax, the ultimate vendor must be registered with the Internal Revenue Service at the time the claim is made. However, registered ultimate vendors cannot make claims for undyed diesel fuel and undyed kerosene sold for use on a farm for farming purposes.

Fuel Not Used For Farming. Fuel is not used on a farm for farming purposes when used in any of the following ways.

- Off the farm, such as on the highway or in noncommercial aviation, even if the fuel is used in transporting livestock, feed, crops, or equipment.
- For personal use, such as mowing the lawn or boating.
- In processing, packaging, freezing, or canning operations.
- In processing crude gum into gum spirits of turpentine or gum resin or in processing maple sap into maple syrup or maple sugar.

All-Terrain Vehicles (ATVs). Gas used in ATVs on a farm for farming purposes, discussed earlier, is eligible for a credit or refund of excise taxes on the fuel. Fuel used in ATVs for nonfarming purposes is not eligible for a credit or refund of the taxes. If ATVs are used both for farming and nonfarming purposes, only that portion of the fuel used for farming purposes is eligible for the credit or refund.

Dyed Diesel Fuel and Dyed Kerosene. The \$.001 leaking underground storage tank (LUST) tax is included on sales of dyed diesel fuel and dyed kerosene and is not refundable.

Penalty. Use of dyed diesel for a taxable use could subject the farmer to the excise tax and a penalty. For example, if a truck used on a farm for farming purposes is also used on the highway (even though in connection with operating the farm), tax applies to the gallons of diesel fuel used (or sold for use) in operating the truck on the highways.

A penalty is imposed on any person who knowingly uses, sells, or alters dyed diesel fuel or dyed kerosene for any purpose other than a nontaxable use. The penalty is the greater of \$1,000 or \$10 per gallon of the dyed diesel fuel or dyed kerosene involved. After the first violation, the \$1,000 portion of the penalty increases depending on the number of violations.

Fuels Used in Off-Highway Business Use. The fuel tax credit may be claimed on fuel used in an off-highway business use.

Off-Highway Business Use. This is any use of fuel in a trade or business or in an income-producing activity. The use must not be in a highway vehicle registered or required to be registered for use on public highways. Off-highway business use generally does not include any use in a motorboat.

Examples

Off-highway business use includes the use of fuels in any of the following ways:

- In stationary machines such as generators, compressors, power saws, and similar equipment;
- For cleaning purposes; and
- In forklift trucks, bulldozers, and earthmovers.

Generally, it does not include nonbusiness, off-highway use of fuel, such as use by minibikes, snowmobiles, power lawn mowers, chain saws, and other yard equipment.

Fuels Used for Household Use or Other than as a Fuel. The fuel tax credit may be claimed for the excise tax on undyed kerosene used for home use or used other than as a fuel. This applies to undyed kerosene purchased and used for home heating, lighting, and cooking. Home use is considered a use other than as a fuel in a propulsion engine. It is not considered an off-highway business use.

Claiming the Credit

A quarterly claim for refund may be claimed on Form 8849, Schedule 1, if the tax is at least \$750 by the end of the quarter. A quarterly claim for refund may not be claimed for excise tax on gasoline and aviation gasoline used on a farm for farming purposes. The credit must be claimed on the farmer's income tax return, using Form 4136 for the actual computation. A farmer may not claim any amounts on Form 4136 that he or she claimed on Form 8849.

IRC Section 6675 Penalty

IRC section 6675 provides that if a person makes a claim related to gasoline used on a farm for an excessive amount, and it was not due to reasonable cause, there is a penalty equal to the greater of the following amounts:

1. Two times the excessive amount; or
2. \$10.

The penalty applies when nonfarmer claimants and custom operators claim the credit, or when farmers claim the credit on the total gallons of gasoline purchased, rather than the amounts used for farming purposes. Form 4136 clearly states what a farm purpose is and who is entitled to make a claim for the credit. Therefore, a farmer making an improper

claim normally does not have reasonable cause, and the penalty should be computed and proposed.

Including the Credit or Refund in Income

The fuel tax credit is considered prepaid, so the farmer will be refunded the amount claimed, even if no tax is due. If the farmer makes a claim for a fuel tax refund, and the fuel taxes were included in the deduction for fuel on Schedule F, income must be included in an amount equal to the claim. Reporting the income, the timing, and the credit, itself, are three important issues in the examination.

Cash Method

If the farmer uses the cash method of accounting and has deducted the full cost of the fuel purchased as an expense on Schedule F, the refund or credit must be included in income. If a quarterly refund is filed, the refund is included in gross income for the tax year in which the refund is received. If the farmer claims a credit on his income tax return, the credit is included in gross income for the tax year in which the Form 4136 is filed. If the credit is claimed on an amended return, the credit amount is included in gross income for the tax year in which the credit is received.

Example

Sharon Brown, a cash basis farmer, filed her 2007 Form 1040 on March 3, 2008. On her Schedule F, she deducted the total cost of gasoline (including \$110 of excise taxes) used on the farm for farming purposes. Then, on Form 4136, she claimed the \$110 as a credit. Sharon reports the \$110 as other income on line 10 of her 2008 Schedule F.

Accrual Method

An accrual method farmer must compute the amount of the credit due at the close of the tax year and include that amount in gross income on Schedule F in that same tax year.

Example

Patty Green, an accrual basis farmer, files her 2007 Form 1040 on April 15, 2008. On Schedule F, she deducts the total cost of gasoline (including \$155 of excise taxes) she used on the farm for farming purposes during 2007. On Form 4136, Patty claims the \$155 as a credit. She reports the \$155 as other income on line 10 of her 2007 Schedule F.

Examination Techniques

Examination issues to be aware of include:

- Credit claims for gasoline used in highway vehicles;

- Gasoline used in custom work;
- Gasoline used for nonfarm purposes; and
- Claims for credits on diesel fuel purchased tax free.

There are several ways to verify the gallons allowable for the credit.

- Many states refund the state taxes paid on gasoline used on the farm. Check to determine if any differences exist between the amount claimed for the state and the federal purposes.
- During the initial interview, ask the farmer which equipment is diesel powered, as opposed to gasoline powered. On today's farms most of the big equipment is diesel powered. Ask the farmer about how many gallons of fuel a piece of equipment uses per hour, per day or per acre, and how much that piece of equipment was used. From this information, it is possible to compute the number of gallons used.
- It is also possible to back into the allowable number of gallons available for the credit. Begin by computing the gallons of gasoline used in highway vehicles and subtract that number from the total gallons of bulk gasoline purchased to arrive at gallons used for farming. In general, the farmer has a good working knowledge of the highway use of vehicles, so ask questions. When looking at the purchase invoices, note the gallons of unleaded gasoline purchased, since it is generally unsuitable for farm-equipment use.
- Request the invoices to determine that the gallons were actually purchased with the tax included. From the invoices, it is possible to determine the total number of gallons of diesel fuel, leaded and unleaded gasoline, and any other special motor fuels purchased. It is also possible to determine from the invoices if the taxes were paid when the fuels were purchased.

To verify the amount of fuel tax credit that must be included in income in the year under examination, all that is necessary, is to inspect the farmer's prior year tax return and note the amount of fuel tax credit claimed in the prior year. This is the same amount that must be included in income for the current year.

Diesel Fuel

One of the largest expenses to a farmer is for the diesel fuel used to operate tractors, combines, motorized machinery, and irrigation pumps. A farmer can buy dyed fuel tax free. Because of severe penalties for using dyed fuel in highway vehicles, the farmer will probably continue purchasing tax paid undyed fuel. Farmers also use the high sulfur fuel that truckers cannot use.

The farmer may have diesel powered trucks, pickups, and automobiles which require taxed fuel. Tax-paid fuel could be obtained from gas station pumps in town or stored in a separate, on-farm fuel tank. Receipts and invoices will indicate if tax is paid. Use of tax-free fuel for taxable highway use from the on farm tanks requires filing Form 720 to pay

the tax. The initial document request and interview should ascertain if there is an issue or concern.

Dyed Diesel

Effective January 1, 1994, the point of taxation on diesel fuel moved from the wholesale distributor level to the terminal rack. Each owner of diesel fuel at the terminal is liable for the tax on the sale of diesel fuel as it leaves the rack system. There is an exception to the tax if the fuel is either dyed red (according to IRS regulations), or dyed blue (according to EPA regulations). The blue fuel is high in sulfur and is for off-road use only. The red fuel is low in sulfur and also for off-road use, but there are some exceptions. Red fuel may be used in highway vehicles by State or local governments, school buses, qualified local buses, and intercity buses, among others.

Gasoline

Gasoline cannot be purchased tax free. The tax paid on this fuel is refunded only by claiming a refundable credit on Form 4136 and attaching it to the income tax return. Many farmers have gasoline powered tractor(s) and/or machinery used for farming that requires claiming the credit. Older and smaller tractors are often gasoline powered, but are mostly used for nonfield or light field work, so the usage and credit should not be large in relation to the total fuel cost.

Since all gasoline is tax paid, there may not be separate, on-farm gas tanks for personal and business use. Thus, there will be no specific record of non-taxable use. The farmer's, and/or preparer's, workpapers can be used to determine the credit, and should indicate the gallons used for highway purposes. Be alert for the number of vehicles used by the farmer and family members. They may be using fuel in personal vehicles from the farm tank and not accounting for that personal fuel.

Table – Basic Rules for Claiming a Credit

This table gives the basic rules for claiming a credit or refund of excise taxes on fuels used for a nontaxable use.

Basic Rules for Claiming a Credit		
Comment	Credit	Refund
Which form to use	Form 4136, Credit for Federal Tax Paid on Fuels	Form 8849, Claim for Refund of Excise Taxes, and Schedule 1 (Form 8849)
Type of form	Annual	Quarterly
When to file	With your income tax return	By the last day of the quarter following the last quarter included in the claim

Basic Rules for Claiming a Credit		
Comment	Credit	Refund
Amount of tax	Any amount	\$750 or more ¹
¹ You may carry over an amount less than \$750 to the next quarter.		

Table - Credit or Refund for a Nontaxable Use of Fuel

This table is used for to determine the credit or refund for a nontaxable use of the fuel listed.

Credit or Refund for a Nontaxable Use of Fuel			
Fuel Used	On a Farm for Farming Purposes	Off-Highway Business Use	Household Use or Use Other Than as a Fuel ¹
Gasoline	Credit only	Credit or refund	None
Aviation gasoline	Credit only	None	None
Undyed diesel fuel and undyed kerosene	Credit or refund by the farmer only	Credit or refund ²	Credit or refund ²
Kerosene for use in aviation	Credit or refund	None	None
Dyed diesel fuel and dyed kerosene	None	None	None
Other Fuels (including alternative fuels) ³	Credit or refund by the farmer only	Credit or refund	None

¹For a use other than as fuel in a propulsion engine.

²Applies to undyed kerosene not sold from a blocked pump or, under certain circumstances, for blending with undyed diesel fuel to be used for heating purposes.

³Other Fuels means any liquid except gas oil, fuel oil, or any product taxable under Internal Revenue Code section 4081. It includes the alternative fuels: liquefied petroleum gas (LPG), "P Series" fuels, compressed natural gas (CNG), liquefied hydrogen, any liquid fuel derived from coal (including peat) through the Fischer-Tropsch process, liquid hydrocarbons derived from biomass, and liquefied natural gas (LNG).

General Business Credit (Form 3800)

IRC section 38 provides for general business credits. Under IRC section 39, generally, any unused credit may be carried back one year and carried forward 20 years. Certain

credits have no carryback period and limited carry forward periods. Unused general business credits are treated as used on a first-in, first out basis by offsetting the earliest earned credits first. The order in which the credits are applied in a tax year is carry forwards to that year (the earliest carry forwards first), the general business credit earned in that year, and the carry back to that year.

All of the following credits are part of the general business credit

Alternative fuel vehicle refueling property credit (Form 8911), IRC section 30C(d)(1)

This credit applies to the cost of any qualified fuel vehicle refueling property placed in service.

Alternative motor vehicle credit, (Form 8910), IRC section 30B(g)(1)

This credit consists of the following four credits for new vehicles placed in service.

- Qualified fuel cell motor vehicle credit,
- Advanced lean burn technology motor vehicle credit
- Qualified hybrid motor vehicle credit
- Qualified alternative fuel motor vehicle credit.

Credit for small employer pension plan startup costs (Form 8881), IRC section 45E

This credit applies to pension plan startup costs of new qualified defined benefit or defined contribution plan (including a 401(k) plan, SIMPLE plan, or simplified employee pension plan. Eligible employers can receive a tax credit of 50% of the first \$1,000 of cost of establishing new eligible retirement plans. To be eligible, the employer must have had 100 or fewer employees who received at least \$5,000 in compensation from the employer for the preceding year.

Empowerment zone and renewal community employment credit (Form 8844), IRC section 1396(a)

A farmer with employees who is engaged in a business in an empowerment zone or renewable community for which the credit is available may qualify for this credit.

New markets credit (Form 8874), IRC section 45D

This credit is for qualified equity investments made in qualified community development entities in low-income or economically disadvantaged areas.

Renewable Electricity Production Credit (Form 8835 & Form 3800), IRC section 45

Section 45(a) provides for a credit for sale of electricity, refined coal, or Indian coal produced in the United States or U.S. possessions from qualified energy resources at a qualified facility. Qualified energy resources and facilities include wind/wind energy facilities, closed loop biomass, poultry waste, open-loop biomass facilities (including waste nutrient facilities), geothermal energy, solar energy, small irrigation power (power generated without any dam or impoundment of water), municipal solid waste, hydropower production, refined coal and Indian coal. Generally, the credit applies to facilities placed in service after October 22, 2004 and before January 1, 2009. IRC section 45 is a component of the general business credit IRC section 38.

Closed-loop biomass is any organic material from a plant that is planted exclusively for use at a qualified facility to produce electricity.

Poultry waste is poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

Open-loop biomass is solid, nonhazardous cellulosic waste material derived from forest related resources, lignin material; or agriculture livestock waste nutrients. Agriculture livestock waste nutrients as defined in section 45 (c)(3) includes bovine, and other bedding material for the disposition of manure.

Forest related resources include: mill and harvesting residues, precommercial thinnings, slash and brush etc. Agriculture sources, includes orchard tree crops, vineyards, grain legumes, sugar and other crop by-products or residues.

Generally, the credit may be claimed for electricity produced from a qualified facility for a 5 or 10 year period, beginning with the date the facility is placed in service. The credit claimed under IRC section 45(a) for electricity produced from qualified facilities may be allocated by an agricultural cooperative among its patrons. IRC section 45(e)(11).

Work opportunity credit (Form 5884) IRC section 51(a)

This credit provides businesses with an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. The welfare-to-work credit and the work opportunity credit have been combined with respect to employees that began work for the employer after December 31, 2006. Employer must obtain certification from a state employment security agency that an employee is a targeted group member.

Investment Credit (Form 3468), IRC section 46

The investment credit is the total of the following credits:

- Rehabilitation credit, IRC section 47,
- Energy Credit, IRC section 48
- Qualified advanced coal project credit, IRC section 48A
- Qualifying gasification project credit, IRC section 48B

Rehabilitation Credit

A farmer might take advantage of the rehabilitation credit. This is an investment credit taken for expenses incurred to rehabilitate or reconstruct certain buildings. The applicable credit rates are 10 percent of the expenses for buildings that were placed in service before 1936, and 20 percent for certified historic structures. The 20 percent credit applies to both residential and nonresidential buildings, while the 10 percent credit applies to nonresidential property only.

To claim the credit the farmer must substantially rehabilitate a building used in a trade or business. The rehabilitation must be done within a 24-month period selected by the farmer, and the expenses must be more than the greater of \$5,000 or the adjusted basis in the building. This credit does not appear to be used much by the farming industry.

Business Energy Investment Credit

The energy credit is equal to 10 percent of the basis of qualified energy property placed in service during the tax year. Energy property includes solar property and geothermal property. Property that uses both qualified solar or geothermal energy and non-qualified energy may also be eligible for the credit.

Basis Adjustment

The investment credit is allowable in the year that the qualified property is first placed in service. The basis of property for which an investment credit is claimed is reduced by 100 percent of the rehabilitation credit and by 50 percent of the energy credit. The reduced basis is used to compute depreciation and any gain or loss on the disposition of the property.

If investment credit is recaptured on property for which an investment credit downward basis adjustment was made, the basis of the property is increased by 100 percent of the recapture amount for the rehabilitation credit and 50 percent of the recapture amount for an energy credit.

Examination Techniques

TRA '86 greatly reduced the use of investment tax credits. The examiner must determine if the farmer is allowed to take any of these credits. If the energy credit is claimed, ensure that the property is actually one of the types for which the credit is allowed (for example, only some areas can use geothermal property in the United States). Finally, if the credit is

allowable, determine if the correct reduction in basis has been made. Make sure credits claimed are not expired credits.

Carrybacks and Carryovers

The rules for the use of unused credits are no different for farmers than for any other taxpayer. Pay close attention to the unused credit. If it was not carried back prior to being carried forward, and the statute of limitations is closed on the return for the year in which the credit originated, the credit carry forward can be disallowed to the extent it should have been carried back.

Examination Techniques

During an examination, make sure the claimed carryover is correct. The best way to do this is to use copies of prior year tax returns. Math errors are often found and credits used have often not been deducted from the carryover amount. An examination of the depreciation schedule may indicate a disposition of assets without a reduction of the credit carryover. An important thing to be aware of is that farmers frequently trade, transfer, gift, or sell assets, and may not recapture the credit. Look for assets that have been removed from the depreciation schedule from one year to the next for an indication that a credit recapture issue may exist. Also, be sure to ask about any abandoned or retired equipment while conducting a tour of the farm.

Recapture of Investment Credit

The recapture rules for farmers, under IRC section 50, are the same as for other taxpayers. However, recapture is usually an issue on farm examinations because farmers frequently trade or otherwise dispose of equipment, and may fail to recapture the credit.

Dispositions

An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when the farmer exchanges or trades worn-out or obsolete assets for new ones. There is also a disposition for recapture purposes if the property ceases to be qualifying property. One of the most common dispositions made by a farmer is the sale or gifting of assets to a related party, often between the farmer and child or grandchild. Both of these dispositions result in a recapture of the credit. A related issue may also arise on the recipient's tax return, since investment credit is not allowed on acquisitions from a related party.

Foreclosure and bankruptcy have been common in the farming industry. A transfer of property by foreclosure is a disposition. Property transferred to a trustee in bankruptcy to liquidate the assets and to make distributions to the creditors is also a disposition, at the time the assets are transferred to the trustee. Not all transfers of property are dispositions. A transfer by a farmer because of a change of doing business does not cause a

disposition. A transfer between spouses due to a divorce and a transfer by reason of the death of the farmer are not dispositions.

Tax Schemes

See www.irs.gov for information on abusive schemes involving tax credits.